

# SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

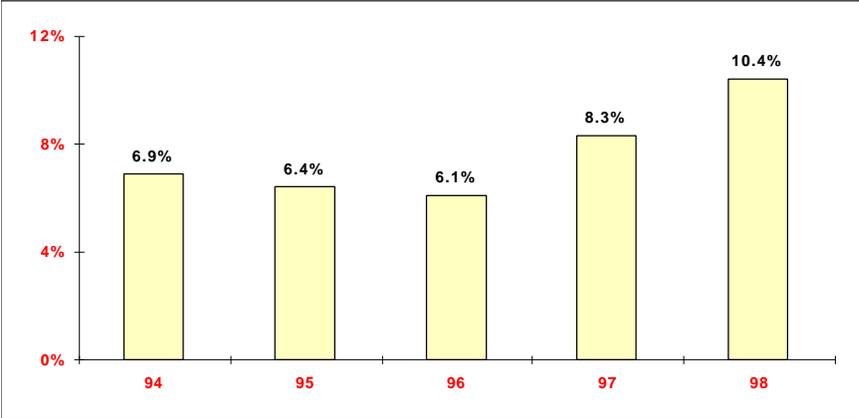
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## Consolidated Highlights

(DOLLARS IN THOUSANDS EXCEPT PER SHARE AMOUNTS)	1998	1997	CHANGE
Operating revenues	<b>\$4,163,980</b>	\$3,816,821	9.1%
Operating expenses	<b>\$3,480,369</b>	\$3,292,585	5.7%
Operating income	<b>\$683,611</b>	\$524,236	30.4%
Operating margin	<b>16.4%</b>	13.7%	2.7 pts.
Net income	<b>\$433,431</b>	\$317,772	36.4%
Net margin	<b>10.4%</b>	8.3%	2.1 pts.
Net income per share – basic	<b>\$1.30</b>	\$.97	34.0%
Net income per share – diluted	<b>\$1.23</b>	\$.93	32.3%
Stockholders' equity	<b>\$2,397,918</b>	\$2,009,018	19.4%
Return on average stockholders' equity	<b>19.7%</b>	17.4%	2.3 pts.
Stockholders' equity per common share outstanding	<b>\$7.14</b>	\$6.05	18.0%
Revenue passengers carried	<b>52,586,400</b>	50,399,960	4.3%
Revenue passenger miles (RPMs) (000s)	<b>31,419,110</b>	28,355,169	10.8%
Available seat miles (ASMs) (000s)	<b>47,543,515</b>	44,487,496	6.9%
Passenger load factor	<b>66.1%</b>	63.7%	2.4 pts.
Passenger revenue yield per RPM	<b>12.62</b>	12.84¢	(1.7)%
Operating revenue yield per ASM	<b>8.76¢</b>	8.58¢	2.1%
Operating expenses per ASM	<b>7.32¢</b>	7.40¢	(1.1)%
Number of Employees at yearend	<b>25,844</b>	23,974	7.8%

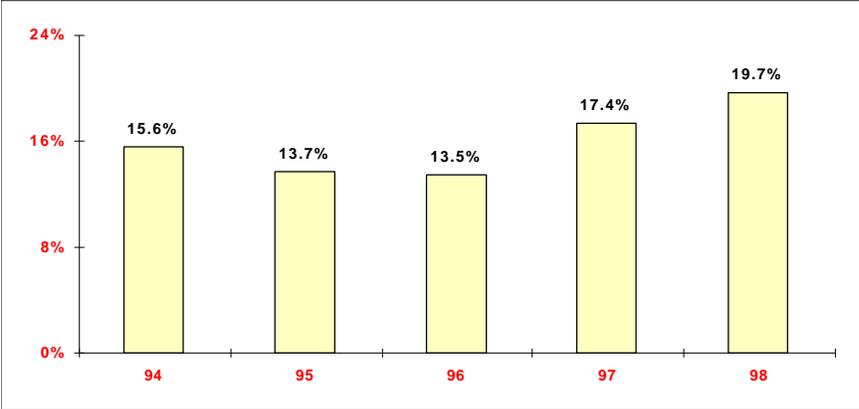
**SOUTHWEST AIRLINES CO. ❤️ SIX STORIES OF FREEDOM**



**Net Margin**



**Net Income Per Share, Diluted**



**Return On Average Stockholders' Equity**

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Freedom means many things to many people. For some of our Customers, Southwest's legendary low fares provide the financial freedom to fly. For others, our frequent flights grant the freedom to fly virtually any time they choose. For still others, our coast-to-coast destinations offer the freedom to fly from California to Florida, and from the Canadian border to the southern tip of Texas. The stories of what this newfound freedom accords our Customers are very heartwarming.

Here are *Six Stories of Freedom*.

Southwest Airlines Co. is the nation's low-fare, high customer satisfaction airline. We primarily serve shorthaul city pairs, providing single-class air transportation, which targets the business commuter as well as leisure travelers. The Company, incorporated in Texas, commenced Customer Service on June 18, 1971, with three Boeing 737 aircraft serving three Texas cities – Dallas, Houston, and San Antonio. At yearend 1998, Southwest operated 280 Boeing 737 aircraft and provided service to 53 airports in 26 states throughout the United States. Southwest has the lowest operating cost structure in the domestic airline industry and consistently offers the lowest and simplest fares. Southwest also has one of the best overall Customer Service records. LUV is our stock exchange symbol, selected to represent our home at Dallas Love Field, as well as the theme of our Employee and Customer relationships.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

To our Shareholders:

1998 was Southwest Airlines' 26th consecutive year of profitability. It was also Southwest Airlines' 26th consecutive year of job security and bounteous Profitsharing for our well-loved and loving People. Our philosophy of achieving low costs and low fares (through high productivity) and maintaining high spirits (through affection and respect for each other) has proved rewarding for our Employees, our Shareholders, and our Customers, for whom Southwest remains, truly, "A Symbol Of Freedom."

Our 1998 earnings of \$433.4 million (diluted net income per share of \$1.23) exceeded the \$317.8 million of 1997 (diluted net income per share of \$.93) by 36.4 percent. At this early juncture in 1999, our load factor, Customer bookings, and unit revenue trends are relatively strong. As a consequence, our preliminary assessment of first quarter 1999 earnings prospects is quite optimistic, barring any serious and precipitous downturn in the U.S. economy or other, uncontrollable adverse occurrences.

We anticipate delivery of 32 New Generation Boeing 737-700s during 1999 and the retirement of six older generation 737-200s. Our 1999 net increment in available seat mile capacity is presently expected to be in the 11 to 12 percent range, although, at this writing, we are also actively pursuing the acquisition of several used 737-300s.

Manchester, New Hampshire, is our newest city and a very proud, productive, and profitable addition to our route system. We thank the people of Providence, of Manchester, and of all New England for their enthusiastic reception and very strong continuing support of Southwest Airlines service.

On March 14, 1999, we will commence serving MacArthur Airport in Islip, Long Island. Thanks to the foresight and vision of the members of the Islip Town Council and Supervisor Pete McGowan, the MacArthur Airport facilities have been expanded and remodeled to accommodate Southwest's introduction of service to the State of New York. We will begin that service with eight nonstop trips to Baltimore/Washington; two to Chicago (Midway); one to Nashville; one to Tampa Bay; and through and

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

connecting service beyond those cities to numerous other Southwest Airlines destinations.

We also plan to begin serving at least one other new city in 1999.

Over a span approaching three decades, our People have overcome the potentially devastating effects of fierce competition; debilitating recessions; and precipitous jet fuel price spikes. They have weathered each adversity because they are truly People for all seasons, bad seasons as well as good and threatening seasons as well as tranquil. They are, in short, great People pursuing a great cause — they are crusaders bringing to ever increasing numbers of Americans the freedom to fly. I applaud their versatility, their strength, their focus, their dedication, and their energy — they are, indeed, incredibly special in mind, heart, and spirit!

Most sincerely,  
Herbert D. Kelleher  
Chairman, President, and Chief Executive Officer  
February 1, 1998

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

“We, the People of Southwest Airlines, give our Customers the freedom to fly. Every Customer is entitled to three simple rights: Low fares, lots of flights, and the friendliest service in the sky.”

— Elizabeth P. Sartain, Vice President — People

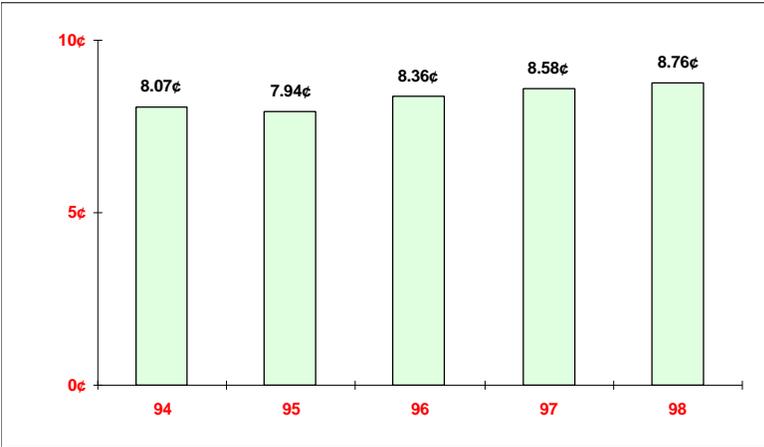
Southwest Airlines stands for freedom and we are committed to providing our Customers something different in the airline industry: everyday low fares and superior Customer Service. That philosophy served us well again in 1998, as we recorded our 26th consecutive year of profitability and our seventh consecutive record profit. Earnings for 1998 were up 36 percent with a net profit margin of 10.4 percent and return on equity of 19.7 percent. This kind of financial performance is tops in our industry, as is our Customer Service. Very different for an airline. But then we are very different.

Our operating strategy is unique in the U.S. airline industry. While the rest of the industry has matured, our niche remains a growth market for Southwest. We are a low-fare, high-frequency, point-to-point, shorthaul air carrier. Our operation is efficiently designed to maximize productivity, which reduces costs and maintains our high quality service. We are the low-cost producer in the U.S. airline industry, and that allows us to profitably deliver on our philosophy of everyday low fares.

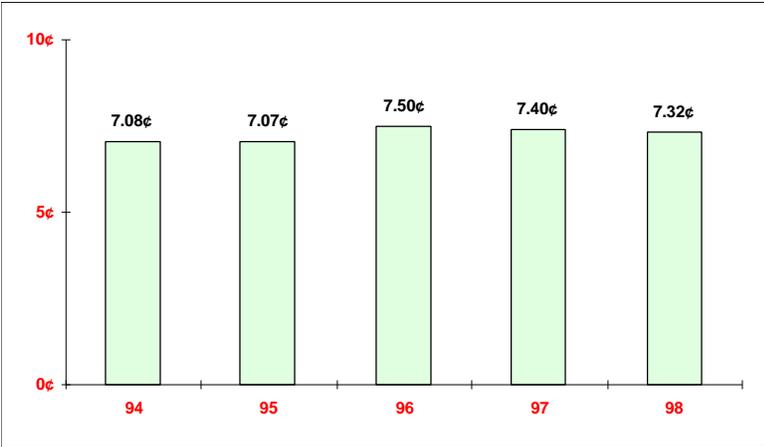
Low cost doesn't mean less service or low wages. Although we offer competitive compensation packages, it is our rich Culture and dedicated People that make Southwest Airlines such a special place. For the second year in a row, Fortune magazine has named Southwest Airlines one of the best companies to work for in America, a testament to the outstanding People and relationships in our Company. Fortune also recognized Southwest as America's most admired airline and one of America's most admired corporations. Finally, Southwest has been recognized as one of the world's safest airlines.

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Low cost doesn't mean low quality. For the third year in a row, Southwest was ranked number one in the National Airline Quality Rating Study, conducted annually by the W. Frank Barton School of Business at Wichita State University and the University of Nebraska at Omaha. The ranking includes 19 separate criteria, including ontime performance, safety, baggage handling, Customer Service, and financial stability. We also have the best Customer Satisfaction ranking of any major U.S. airline, based on statistics published by the U.S. Department of Transportation, for the eighth year in a row.



**Operating Revenues Per Available Seat Mile**



**Operating Expenses Per Available Seat Mile**

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*Caleb Unland's idea of freedom is not just pursuing a dream. It's achieving it. Which he did at the ripe young age of seven. That's when he won his first national karate title. And when he and his mom first started flying with us. Now anytime Caleb competes, they fly to the nearest Southwest destination, rent a car for the rest of the way, and still save a lot of money. It's worked out really well. And Caleb's mom tells us he loves flying with us. He particularly enjoys buckling our black belts.*

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

“We give our People the freedom to keep fares low in every city we serve. These are not merely introductory fares, they are our everyday low fares — and they are low by philosophy, not expediency.”

— Gary C. Kelly, Vice President — Finance & CFO

Low fares, every seat, every day. That's what makes Southwest so different. And that's what Customers want: low fares so they have the freedom to fly. Low fares are even more important in our shorthaul market niche, as Customers have ground transportation as a viable alternative. Therefore, we have to charge low fares to succeed, regardless of what our airline competitors charge.

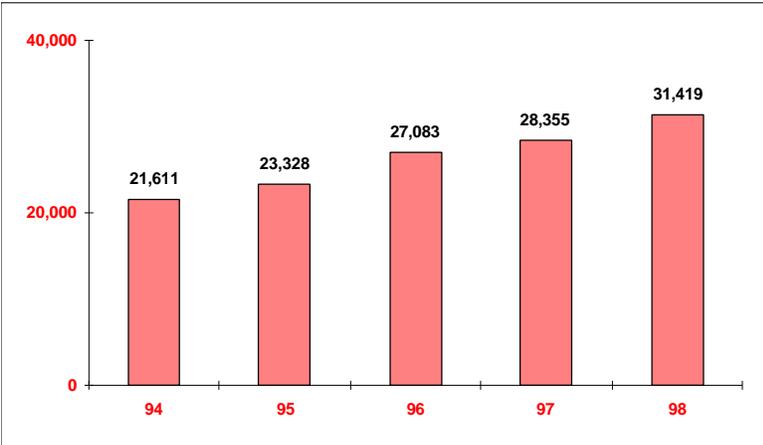
We are the low-fare police in the U.S. airline industry, THE Low-Fare Airline. Customers think of Southwest when they think of low fares. In a July 1997 Consumer Reports survey, Southwest was ranked as having the lowest fares of the nine major airlines rated. We are committed to maintaining that reputation.

Well over 100 communities requested service from Southwest last year because of our low-fare reputation and the knowledge of what low fares and high quality service can produce. When Southwest Airlines enters a market and slashes fares, the number of travelers increases significantly, often three- and four-fold. The U.S. Department of Transportation refers to this surge in air traffic and its favorable economic impact as the “Southwest Effect.” This is especially true in shorthaul markets where people were forced to travel by automobile or other modes of ground transportation because air travel was simply not affordable prior to Southwest service.

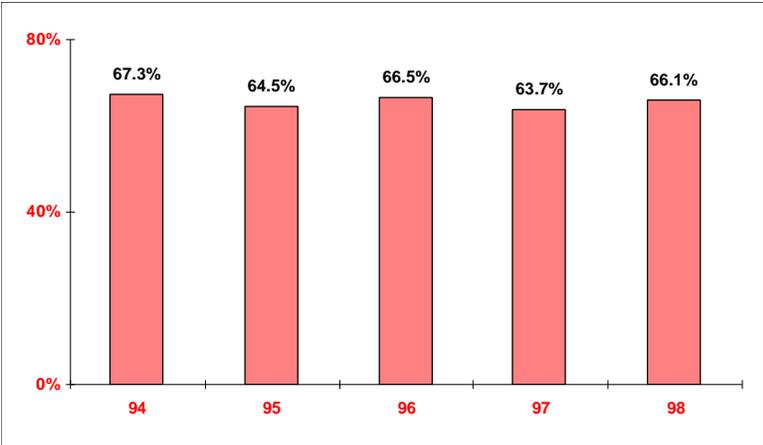
Since we charge low fares every day, we tend to dominate the markets we serve with frequent flights. We consistently rank first in market share in 80 to 85 percent of our top city pairs and, in the aggregate, generate a 60 to 65 percent share in the top 100 city-pair markets served by Southwest. We rank first or second in Customer boardings at the majority of our 53 airports served. Overall, we are now the fourth largest airline in the U.S. in terms of passengers boarded.

**SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Our fare structure is simple, reliably low, and easy to understand. In fact, even our discounted, restricted tickets are “Customer friendly” as they are reusable without a rebooking fee. Finally, we make buying a seat on Southwest more convenient with our Ticketless Travel. Approximately 70 percent of our Customers now fly Ticketless.



**Revenue Passenger Miles (in millions)**



**Passenger Load Factor**

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*To Steve Salvatori, freedom means being able to get where you want to go whenever you want to go there. And where Steve wants to go is just about everywhere Southwest Airlines flies. See, Steve's trying to run one marathon in as many different states as he can. Maybe even all 50 by his 50th birthday. He says that with our low fares and frequent flights, he's able to meet his goals. And he says running's a great way to stay young, and we should join him. We'll see.*

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

“We give our People the freedom to provide the best Customer Service in the airline industry – we call it Positively Outrageous Service. Our Customers simply call it Southwest hospitality.”

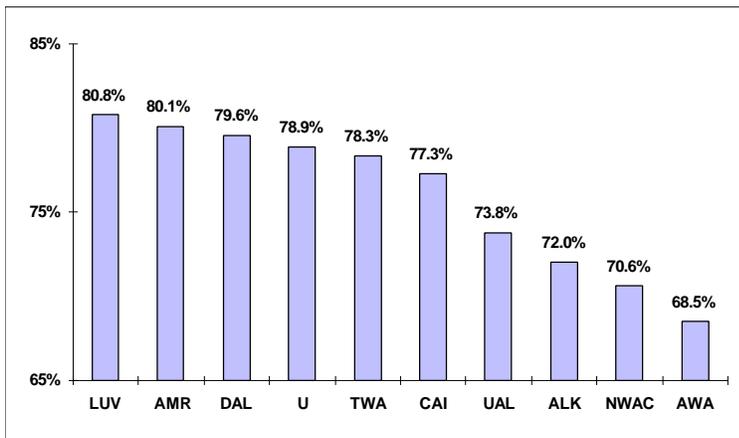
— Colleen C. Barrett, Executive Vice President — Customers

It's not enough to charge low fares and produce the lowest operating costs. In a service business such as ours, safe, high quality Customer Service is required. According to U.S. Department of Transportation statistics, we consistently rank first of all the major U.S. airlines in overall Customer Satisfaction. And Money magazine ranked Southwest number one in its November 1997 survey on airline service. Of course, it's People who deliver service and that's where our Customer Service commitment begins. We go to great lengths to hire great People with the right attitude. Once hired, we provide a unique and supportive work environment, which encourages our Employees to be creative and have fun. As a result, our People tend to go out of their way to ensure our Customers have an enjoyable flight and are treated like guests.

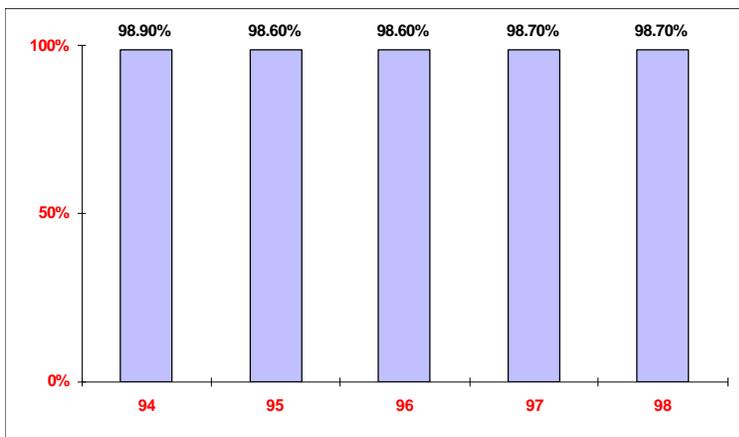
Next to low fares, operating a dependable and reliable schedule is the most important aspect of flying to Customers. Through a combination of efficient aircraft scheduling, careful selection of airports, and our highly productive, hardworking, and motivated People, we consistently operate an “ontime airline.” As important, we have one of the best records in our industry with respect to the fewest number of canceled flights. We have an all-jet fleet of Boeing 737 aircraft, which is one of the youngest in the world. To accommodate our Customers' hectic schedules and minimize the total trip time, we offer quick and simple ticketing and boarding procedures. Our inflight beverage service is fast and friendly, perfectly suited for our market niche. The seating configuration is all coach with comfortable seats and ample room.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

We offer the most generous frequent flyer program in the U.S. airline industry. After purchasing and flying only eight roundtrips on Southwest, Customers receive a roundtrip ticket, good for travel anywhere on Southwest's system for up to a year. That's why we call our program Rapid Rewards. Rapid Rewards Customers can also receive flight credits through purchases with our travel partners (Alamo, Hertz, Budget, American Express, Diners Club, and MCI), as well as through the use of the Southwest Airlines Visa card.



**Ontime Performance** (for the year ended December 31, 1998)



**Completion Factor** (completed flights versus scheduled flights)

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*Ask Thanh Giang Nguyen what freedom means to her, and she'll tell you it means being able to keep a promise. Even if it takes 11 years to pay it off. See, when Thanh was 13, she promised her pen pal Heidi that she'd be a bridesmaid in her wedding. "Some day." But when that day finally came, it looked like the trip might be a little out of her price range. Until she called us. And soon met her very best friend for the very first time. Now Thanh promises to stay loyal to Southwest. With her track record, we don't doubt it.*

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

“We give our People the freedom to build schedules that ensure our Customers have the flexibility to fly where they want to fly, when they want to fly there.”

— Gary A. Barron, Executive Vice President — Chief Operations Officer

Southwest offers lots of daily flights to the cities we serve. That’s the “high frequency” part of our shorthaul, low-fare, high-frequency strategy. It helps keep our asset utilization high and, therefore, our unit cost low. But, more importantly, it offers convenience, especially to our business Customers. Our operation was built to meet the needs of the shorthaul business traveler.

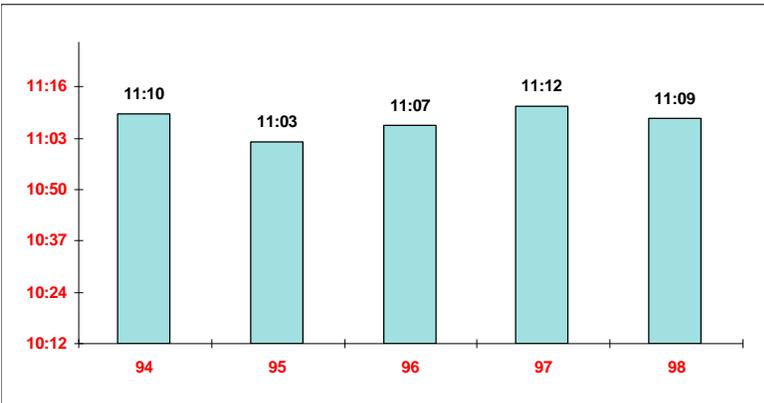
Currently, we operate over 2,300 daily flights, or almost 45 departures per airport. In fact, we have seven airports with over 100 flights per day. This is very different from our major hub-and-spoke airline competitors, which offer lots of flights from just a few hub cities. We offer numerous flights almost everywhere we serve.

With our shorthaul and efficiency focus, we schedule our aircraft on a point-to-point, rather than hub-and-spoke, basis. Consequently, approximately 75 percent of our Customers fly nonstop, in sharp contrast to the rest of the industry where many passengers connect.

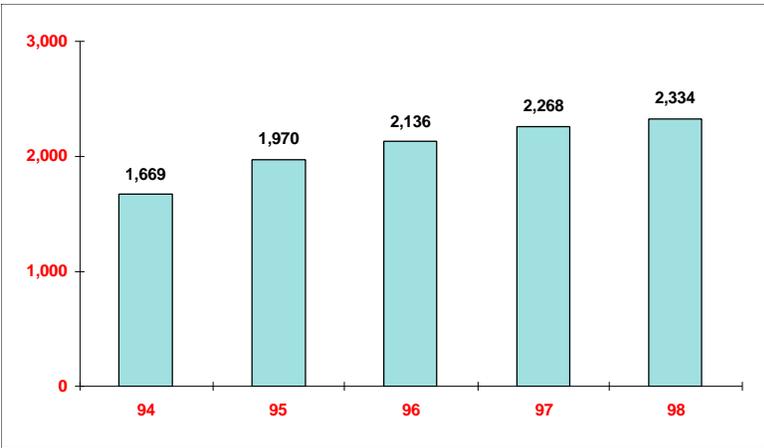
Southwest’s point-to-point route system, as compared to hub-and-spoke, provides our Customers with extensive nonstop routings that minimize connections, delays, and travel time. Because of our high frequencies and high productivity, our airport turnaround time is minimal and leads the industry at approximately 20 minutes. So, for the 25 percent of our Customers who don’t fly us nonstop, ground time and, therefore, total trip time is minimized.

**SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Our scheduling philosophy is based on our ability to generate a substantial amount of traffic with our everyday low fares. By creating more demand, we can offer lots of convenient flights from the cities we serve. To further increase our operating efficiency, we try to avoid congested airports, especially our competitors' hubs. We seek convenient satellite or downtown airports such as Dallas Love Field, Houston Hobby, Chicago Midway, Oakland, Providence, Ft. Lauderdale, Burbank, Baltimore, and Manchester, which also reduces total trip time and transportation expenses to and from the airport. By avoiding congested hub airports, we also enhance our ability to sustain high ontime performance.



**Aircraft Utilization (hours and minutes per day)**



**Average Daily Departures**

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*Talk to Laurence Parent about freedom and he'll tell you it means not having to plan ahead. Which is especially important when dealing with Texas weather. See, Laurence is a photographer, and he sometimes gets some crazy assignments. Like shooting snow in Texas. So when he got the call that there was an inch or two in the Guadalupe Mountains, he called Southwest. Good thing, too. If he had to wait for some of the other airlines, he just might have ended up with nothing but a really well-lit picture of slush.*

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

“We give our People the freedom to consider destinations in all regions of our country. We now fly from the Pacific Ocean to the Atlantic Ocean, and from the Canadian border to the border of Mexico.”

— Joyce C. Rogge, Vice President — Marketing

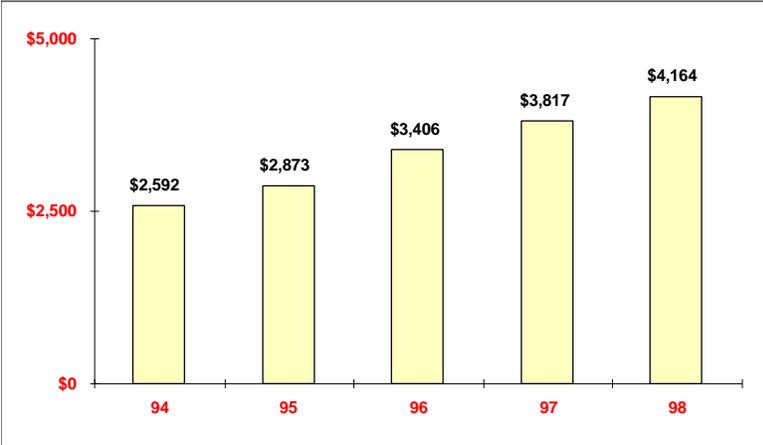
Our route system has grown at an annualized rate of approximately 14 percent over the last decade. In 1988, we served 29 airports with 850 daily flights and earned a profit of \$58 million. Since then, we have added 24 new destinations and 1,520 more daily flights and increased our profits 650 percent to \$433.4 million in 1998.

From our beginnings as an intra-Texas airline in the 1970s, we expanded our point-to-point network in the 1980s into neighboring states with the advent of deregulation. In the 1980s, we were also earnestly developing our western region, primarily Phoenix, Las Vegas, and California. In late 1991, we were able to significantly expand our Chicago operation and ultimately added destinations such as Cleveland, Columbus, and Louisville, along with Baltimore on the east coast. On December 31, 1993, we further expanded our network by acquiring Morris Air in Salt Lake City and adding destinations in the northwest, such as Seattle and Portland. In 1996, we landed in Florida and the northeast (Providence, Rhode Island). And this year, we continued our northeast expansion with the addition of Manchester, New Hampshire.

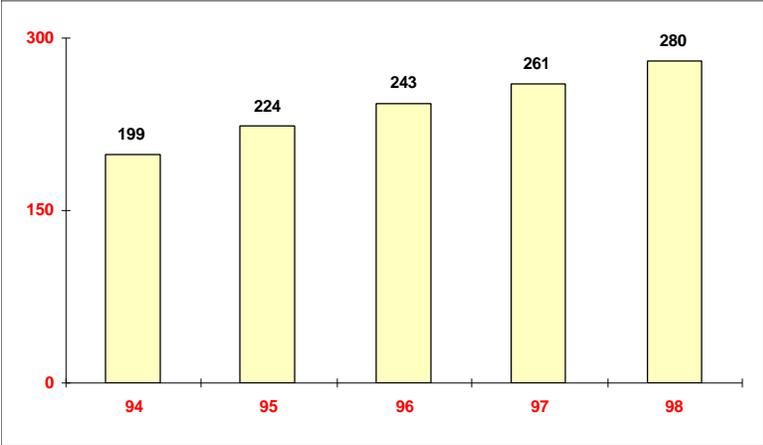
We're the largest carrier at most of the airports we serve. For example, our top ten cities' daily departures are currently: Phoenix, 169; Houston Hobby, 146; Las Vegas, 141; Dallas, 139; Los Angeles, 118; Oakland, 112; Chicago, 102; St. Louis, 88; San Diego, 76; and Baltimore, 74. Our heartland region (Texas and surrounding states) constitutes about 16 percent of our capacity. Our western region has grown to be our largest, at 49 percent of our system. The midwest is about 16 percent, while the east, our newest and fastest growing region, has grown to about 19 percent of our total capacity.

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While our focus has been shorthaul, we have lately augmented our service with longhaul flights (over 750 miles). We have added more longhaul flights over the last three years to mitigate the effects of new ticket taxes, which penalize shorthaul fares, and to take advantage of excellent route opportunities. Longhaul flights still constitute ten percent or less of our flights but are very successful and an excellent complement to our established shorthaul route network.



**Operating Revenues** (in millions)



**Fleet Size** (at yearend)

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*To LaFaye Baker, freedom is all about being able to work with interesting characters. Like vampires, robbers, and maybe even the occasional cyborg or two. You see, LaFaye is a Hollywood stuntwoman. Maybe you've seen her dodging some hot lava recently. Or you may have seen her on your last Southwest Airlines flight. LaFaye tries to fly Southwest because she can go just about anywhere at a moment's notice. Which means she can concentrate on the more important stuff. Like coming up with a few ad-libs for her films. Usually something like "Ouch."*

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

“We give our People the freedom to forecast the future – everything from the expansion of our fleet to the expansion of our system. The future, we’re proud to say, looks very bright.”

— John G. Denison, Executive Vice President — Corporate Services

Strategically, we are well positioned to take advantage of the tremendous growth opportunities that exist in our low-fare, shorthaul, point-to-point market niche. Our financial position is exceptionally strong, with leverage (including off-balance-sheet aircraft leases) of less than 50 percent. Earnings in 1998 capped a string of five years with annualized growth of approximately 23 percent, with the highest profit margins in 17 years. Our return on capital was just below 20 percent versus a cost of capital of under nine percent.

Our cost structure is well below all our airline competitors and under control. Significant improvements have been made over the last several years and we have aggressive plans to control costs in future years.

Our route system is as strong and diverse as it has ever been. It spans the entire continental U.S. with substantial presence in the markets served. We still carry only seven percent of domestic traffic and have opportunities to significantly expand our route system in both new and existing cities.

Our aircraft fleet is young, well maintained, and strategically matched with our market niche. Yet it is flexible enough to meet our needs on longhaul flights. Our fleet growth will continue in 1999 as we add 32 new 737-700s from Boeing, with the intention of adding at least two more preowned -300s. Considering the planned 1999 retirement of six -200s, our fleet will grow to 308 737s, a capacity increase of roughly 12 percent. Our goal for the indefinite future is to grow capacity a minimum of ten percent per year.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

1998 was the first full year of operation of the New Generation Boeing 737-700. We have been delighted with its performance as it flies quieter, faster, farther, and higher and is more fuel-efficient than its -300 predecessor.

Our new city expansion opportunities are numerous. We intend to continue to add new cities annually and generally at the rate of two to three per year. As we currently serve only 53 airports, we have lots of new cities to choose from. For 1999, we presently plan to add at least two new cities. In December 1998, we announced the opening of service to MacArthur Airport in Islip, New York, on Long Island, in March 1999. A second new destination will be announced later this year.

<b>737 Type</b>	<b>Seats</b>	<b>Average Age (Yrs.)</b>	<b>Number of Aircraft</b>
-200	122	17.2	39
-300	137	7.7	191
-500	122	7.7	25
-700	137	0.5	25
<b>Total</b>	<b>134</b>	<b>8.4</b>	<b>280</b>

### **Jet Fleet** (at December 31, 1998)

	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>Total</b>
Firm Orders	32	21	21	21	5	5	–	–	105
Options	–	–	–	–	13	13	18	18	62
<b>Total</b>	<b>32</b>	<b>21</b>	<b>21</b>	<b>21</b>	<b>18</b>	<b>18</b>	<b>18</b>	<b>18</b>	<b>167</b>

### **Boeing 737-700 Firm Orders And Options**

SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

*To Mike Young, freedom means being able to do things the way you want. Like decorating a restaurant with car parts and serving up plates of burritos as big as your face. So when it came time to expand the funky dining experience to folks who'd never experienced it, he and his partner came up with a pretty simple business plan. Only expand to cities that Southwest flies to. That way, managers are free to fly from one restaurant to another at a moment's notice. And still have the cash for a round of margaritas.*

**SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

“We give America the freedom to fly — from the Atlantic Ocean to the Pacific Ocean, and from the Canadian border to the border of Mexico. To all our Customers, we are proud to say, ‘You are now free to move about the country.’”



**California 22%**  
**Remaining West 27%**  
**East 19%**  
**Heartland 16%**  
**Midwest 16%**  
**Southwest’s Capacity By Region**

**Southwest 63%**  
**Other Carriers 37%**  
**Southwest’s Market Share**  
*(Southwest’s top 100 city-pair markets)*

**Southwest Airlines Co.**  
**1998 Annual Report**  
**Financial Review**

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

**YEAR IN REVIEW**

In 1998, Southwest posted a record annual profit for the seventh consecutive year and a profit for the 26th consecutive year. The Company also posted record operating revenues; record operating income; the highest net profit margin since 1981 of 10.4 percent; and the highest operating profit margin since 1981 of 16.4 percent. The Company experienced strong revenue growth, low unit costs, and continued strong demand for our product.

At the end of 1998, Southwest served 52 cities in 26 states. We added service to Manchester, New Hampshire, in June 1998 and have been very pleased with the results. We have plans to add new service to Islip, New York, on Long Island in March 1999 and will begin serving at least one other new city in 1999. With the net addition of at least 28 aircraft in 1999 (32 new Boeing 737-700s, two used -300s, and the retirement of six older -200s), we will also continue to add additional flights to cities we already serve. We are actively pursuing the acquisition of additional used 737-300s that would add to our 1999 expansion efforts.

During 1998, Boeing experienced production delays related to the 737 production line. These production delays, for the most part, have been remedied by Boeing and we currently do not anticipate any significant delays in 1999.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

Also during 1998, the Company's Customer Service and Reservations Sales Agents, represented by the International Association of Machinists and Aerospace Workers, AFL-CIO, and Flight Dispatchers, represented by the Southwest Airlines Employees Association, ratified collective bargaining agreements which will run through the years 2002 and 2009, respectively. In addition, in September 1998, the Company's pilots voted to continue their ten-year agreement with the Company which next becomes amendable in 2004.

### RESULTS OF OPERATIONS

**1998 COMPARED WITH 1997** The Company's consolidated net income for 1998 was \$433.4 million (\$1.23 per share, diluted), as compared to the corresponding 1997 amount of \$317.8 million (\$.93 per share, diluted), an increase of 36.4 percent. The prior years' earnings per share amounts have been restated for the 1998 three-for-two stock split (see Note 7 to the Consolidated Financial Statements).

**OPERATING REVENUES** Consolidated operating revenues increased by 9.1 percent in 1998 to \$4,164.0 million, compared to \$3,816.8 million for 1997. This increase in 1998 operating revenues was derived primarily from an 8.9 percent increase in passenger revenues as a result of a 10.8 percent increase in revenue passenger miles (RPMs) offset by a 1.7 percent decrease in passenger revenue yield per RPM. While Southwest's passenger revenues increased 8.9 percent in 1998, the RPM yield decline resulted from the higher load factors, a 6.0 percent increase in passenger trip lengths, and higher federal excise taxes on domestic tickets. Assuming load factors and passenger trip lengths continue to be above year-ago levels, RPM yields will continue this trend. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, competitive responses from other air carriers and general economic conditions.)

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

The 10.8 percent increase in RPMs in 1998 exceeded the 6.9 percent increase in available seat miles (ASMs), resulting in an increase in load factor from 63.7 percent in 1997 to 66.1 percent in 1998. The 1998 ASM growth resulted from the net addition of 19 aircraft during the year. The load factor was 59.2 percent in January 1999, up 5.2 points from January 1998.

Freight revenues in 1998 were \$98.5 million, compared to \$94.8 million in 1997. The 3.9 percent increase in freight revenues fell short of the 6.9 percent increase in ASMs for the same period. United States mail revenue declined 2.5 percent in 1998 and 9.4 percent for fourth quarter 1998 as the postal service continues to shift away from commercial carriers. This trend is expected to continue in 1999. Other air freight revenues increased 8.5 percent in 1998 due to increased capacity.

Other revenues increased by 22.7 percent in 1998 to \$101.7 million, compared to \$82.9 million in 1997. This increase is primarily due to increased revenues from the sale of frequent flyer segment credits to participating partners in the Company's Rapid Rewards frequent flyer program.

***OPERATING EXPENSES*** Consolidated operating expenses for 1998 were \$3,480.4 million, compared to \$3,292.6 million in 1997, an increase of 5.7 percent, compared to the 6.9 percent increase in capacity. Operating expenses per ASM decreased 1.1 percent in 1998, compared to 1997, primarily due to a 26.9 percent decrease in average jet fuel price. The decrease in average jet fuel prices was offset by a \$36.1 million increase in Profitsharing and Employee savings plan contributions and an increase in maintenance costs primarily due to unusually low aircraft engine overhaul costs in the first half of 1997.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

Unit costs are expected to continue to benefit in first quarter 1999, versus first quarter 1998, from lower jet fuel prices. Excluding jet fuel costs, operating expenses per ASM are expected to increase in first quarter 1999 compared to first quarter 1998 primarily due to higher Profitsharing and Employee savings plan contributions and increased advertising primarily related to the opening of Islip, New York, on Long Island on March 14, 1999. (The immediately preceding two sentences are forward-looking statements which involve uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, the largely unpredictable levels of jet fuel prices.)

Operating expenses per ASM for 1998 and 1997 were as follows:

### OPERATING EXPENSES PER ASM

	1998	1997	Increase (Decrease)	Percent Change
Salaries, wages, and benefits	<b>2.35¢</b>	2.26¢	.09¢	4.0%
Employee profitsharing and savings plans	<b>.35</b>	.30	.05	16.7
Fuel and oil	<b>.82</b>	1.11	(.29)	(26.1)
Maintenance materials and repairs	<b>.64</b>	.58	.06	10.3
Agency commissions	<b>.33</b>	.35	(.02)	(5.7)
Aircraft rentals	<b>.43</b>	.45	(.02)	(4.4)
Landing fees and other rentals	<b>.45</b>	.46	(.01)	(2.2)
Depreciation	<b>.47</b>	.44	.03	6.8
Other	<b>1.48</b>	1.45	.03	2.1
Total	<b>7.32¢</b>	7.40¢	(.08)¢	(1.1)%

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Salaries, wages, and benefits per ASM increased 4.0 percent in 1998. This increase resulted primarily from a 6.9 percent increase in 1998 average salary and benefits cost per Employee. The increase in average salary and benefits cost per Employee primarily is due to higher effective wage rates, lower productivity in 1998 caused by Boeing aircraft delivery delays, and increased health care and workers' compensation costs.

Profitsharing and Employee savings plans expense per ASM increased 16.7 percent in 1998, primarily due to higher earnings available for profitsharing.

Fuel and oil expenses per ASM decreased 26.1 percent in 1998, primarily due to a 26.9 percent decrease from 1997 in the average jet fuel cost per gallon. The average price paid for jet fuel in 1998 was \$.4567 compared to \$.6246 in 1997. During fourth quarter 1998, the average cost per gallon decreased 28.0 percent to \$.4346 compared to \$.6040 in fourth quarter 1997. In January 1999, fuel prices averaged approximately \$.38 per gallon. Year-over-year decreases in jet fuel prices are expected to continue in first quarter 1999 due to the continued oversupply of crude oil and related products, along with the effects of the Company's current fuel hedging positions. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, the largely unpredictable levels of jet fuel prices.)

Maintenance materials and repairs per ASM increased 10.3 percent in 1998, compared to 1997, primarily as a result of an unusually low number of aircraft engine overhauls in the first six months of 1997. Fourth quarter 1998 maintenance materials and repairs per ASM increased 3.2 percent over fourth quarter 1997. We expect modest year-over-year unit-cost growth for maintenance materials and repairs in 1999. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, any unanticipated required aircraft airframe or engine repairs.)

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

Agency commissions per ASM decreased 5.7 percent in 1998, when compared to 1997, primarily due to a decrease in the percentage of commissionable sales.

Aircraft rentals per ASM decreased 4.4 percent in 1998, compared to 1997, primarily due to a lower percentage of the aircraft fleet being leased.

Depreciation expense per ASM increased 6.8 percent in 1998, compared to 1997, primarily due to a higher percentage of the aircraft fleet being owned. Effective January 1, 1999, the Company will revise its estimated useful lives of its Boeing 737-300/500 aircraft from 20 years to 23 years. This change in accounting estimate will decrease aircraft depreciation by approximately \$25 million in 1999.

Other operating expenses per ASM increased 2.1 percent in 1998, compared to 1997, primarily due to increased costs resulting from the Year 2000 remediation program and increased revenue related costs such as credit card processing and communications, offset by lower insurance costs. Advertising costs are expected to increase in first quarter 1999 as a result of opening a new city in March 1999. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results. Such uncertainties include, but may not be limited to, competitive responses from other air carriers and general economic conditions.)

*OTHER* "Other expenses (income)" included interest expense, capitalized interest, interest income, and nonoperating gains and losses. Interest expense decreased \$7.2 million in 1998 primarily due to the February 1998 redemption of \$100 million of senior unsecured 9 1/4% Notes originally issued in February 1991. Capitalized interest increased \$5.8 million in 1998 as a result of higher 1998 progress payment balances. Interest income for 1998 decreased primarily due to lower invested cash balances. Nonoperating gains in 1998 primarily included contractual penalties due from Boeing as a result of aircraft delivery delays.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

**INCOME TAXES** The provision for income taxes, as a percentage of income before taxes, was unchanged from 1997 to 1998.

**1997 COMPARED WITH 1996** The Company's consolidated net income for 1997 was \$317.8 million (\$.93 per share, diluted), as compared to the corresponding 1996 amount of \$207.3 million (\$.61 per share, diluted), an increase of 53.3 percent.

**OPERATING REVENUES** Consolidated operating revenues increased by 12.1 percent in 1997 to \$3,816.8 million, compared to \$3,406.2 million for 1996. This increase in 1997 operating revenues was derived primarily from an 11.3 percent increase in passenger revenues as a result of a 4.7 percent increase in RPMs and a 6.4 percent increase in passenger revenue yield per RPM. Southwest's passenger revenues benefited from a strong U.S. economy, strong demand for air travel, increased fares, and a favorable mix of higher yielding fares.

The 4.7 percent increase in RPMs in 1997, coupled with a 9.2 percent increase in ASMs, resulted in a decrease in load factor from 66.5 percent in 1996 to 63.7 percent in 1997. The decrease in load factor was primarily the result of less promotional fare activity in 1997. The 1997 ASM growth resulted from the addition of 18 aircraft during the year.

Freight revenues in 1997 were \$94.8 million, compared to \$80.0 million in 1996. The 18.4 percent increase in freight revenues exceeded the 9.2 percent increase in ASMs for the same period primarily due to an increase in United States mail services and increased air freight volumes resulting, in part, from the United Parcel Service labor strike during third quarter 1997.

Other revenues increased by 45.6 percent in 1997 to \$82.9 million, compared to \$56.9 million in 1996. This increase is primarily due to the sale of frequent flyer segment credits to participating partners in the Company's Rapid Rewards frequent flyer program.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

*OPERATING EXPENSES* Consolidated operating expenses for 1997 were \$3,292.6 million, compared to \$3,055.3 million in 1996, an increase of 7.8 percent, compared to the 9.2 percent increase in capacity. Operating expenses per ASM decreased 1.3 percent in 1997, compared to 1996, primarily due to lower jet fuel prices; lower aircraft engine repair costs; and favorable results from numerous Companywide cost reduction efforts.

Salaries, wages, and benefits per ASM increased 1.8 percent in 1997. This increase resulted primarily from a 2.4 percent increase in 1997 average salary and benefits cost per Employee, partially offset by slower growth in the number of Employees. The increase in average salary and benefits cost per Employee primarily is due to increased health care costs.

The Company's Flight Attendants are subject to an agreement with the Transport Workers Union of America, AFL-CIO (TWU), which became amendable May 31, 1996. The Company reached an agreement with the TWU, which was ratified by its membership in December 1997. The new contract becomes amendable in May 2002.

Profitsharing and Employee savings plans expense per ASM increased 30.4 percent in 1997, primarily due to higher earnings available for profitsharing.

Fuel and oil expenses per ASM decreased 6.7 percent in 1997, primarily due to a 4.6 percent decrease from 1996 in the average jet fuel cost per gallon, coupled with a slight decrease in the average fuel burn rate from 1996. The average price paid for jet fuel in 1997 was \$.6246 compared to \$.6547 in 1996. During fourth quarter 1997, the average cost per gallon decreased 17.5 percent to \$.6040 compared to \$.7323 in fourth quarter 1996.

Maintenance materials and repairs per ASM decreased 6.5 percent in 1997, compared to 1996, primarily as a result of lower engine overhaul costs in the first three quarters of 1997, when compared to the same periods in 1996.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

On August 1, 1997, the Company signed a ten-year engine maintenance contract with General Electric Engine Services, Inc. (General Electric). Under the terms of the contract, Southwest will pay General Electric a rate per flight hour in exchange for General Electric performing substantially all engine maintenance for the CFM56-3 engines on the 737-300 and 737-500 aircraft. The Company has a similar agreement with General Electric with respect to the engines on the 737-700 aircraft. Maintenance on the Pratt & Whitney JT8-D engines on the 737-200 aircraft will continue to be performed by General Electric on a time and materials basis. By consolidating its engine repair work and committing to ten years, Southwest believes it will spend substantially less over the course of the contract versus what it would have spent absent this new agreement. (The immediately preceding sentence is a forward-looking statement which involves uncertainties that could result in actual results differing materially from expected results; such uncertainties include the number of unscheduled engine removals, labor rates, and competition in the engine overhaul market.)

Agency commissions per ASM remained unchanged in 1997, when compared to 1996, as the mix of commissionable sales was relatively unchanged.

Aircraft rentals per ASM decreased 4.3 percent in 1997, compared to 1996, primarily due to a lower percentage of the aircraft fleet being leased.

Depreciation expense per ASM decreased 2.2 percent in 1997, compared to 1996, due to an increase in the average life of depreciable assets.

Other operating expenses per ASM decreased 4.0 percent in 1997, compared to 1996, primarily due to lower credit card processing costs, insurance rates, passenger costs, communications costs, and favorable results from numerous other Companywide cost reduction efforts.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

*OTHER* “Other expenses (income)” included interest expense, capitalized interest, interest income, and nonoperating gains and losses. Interest expense increased \$4.2 million in 1997 primarily due to the February 1997 issuance of \$100 million of senior unsecured 7 3/8% Debentures due March 1, 2027. Capitalized interest decreased \$2.5 million in 1997 as a result of the timing of payments related to aircraft purchase contracts. Interest income for 1997 increased \$10.8 million primarily due to higher invested cash balances.

*INCOME TAXES* The provision for income taxes, as a percentage of income before taxes, decreased in 1997 to 38.5 percent from 39.3 percent in 1996. The decrease resulted from lower effective state tax rates, including a reduced California income tax rate.

### **LIQUIDITY AND CAPITAL RESOURCES**

Cash provided from operations was \$886.1 million in 1998, compared to \$610.6 million in 1997.

During 1998, capital expenditures of \$947.1 million primarily were for the purchase of 22 new 737-700 aircraft and four used 737-300 aircraft along with progress payments for future aircraft deliveries. In February 1998, the Company redeemed \$100 million of senior unsecured 9 1/4% Notes originally issued in February 1991. At December 31, 1998, capital commitments of the Company primarily consisted of scheduled aircraft acquisitions and related flight equipment.

As of July 22, 1998, the Board of Directors increased the Company’s authorization to repurchase shares of its outstanding common stock to \$100 million. The Company completed this repurchase program during third quarter 1998, resulting in the repurchase of approximately 4.9 million post-split shares.

As of December 31, 1998, Southwest had 105 new 737-700s on firm order, including 32 to be delivered in 1999, with options to purchase another 62. Aggregate funding required for firm commitments approximated \$2,492.5 million through the year 2004, of which \$715.9 million related to 1999. See Note 2 to the Consolidated Financial Statements for further information.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

The Company has various options available to meet its capital and operating commitments, including cash on hand at December 31, 1998, of \$378.5 million, internally generated funds, and a revolving credit line with a group of banks of up to \$475 million (none of which had been drawn at December 31, 1998). In addition, the Company will also consider various borrowing or leasing options to maximize earnings and supplement cash requirements.

The Company currently has outstanding shelf registrations for the issuance of \$318.8 million of public debt securities, which it currently intends to utilize for aircraft financings in 1999 and 2000.

### **MARKET RISK**

In 1997, the Securities and Exchange Commission issued new rules (Item 305 of Regulation S-K) which require disclosure of material risks, as defined in Item 305, related to market risk sensitive financial instruments. As defined, Southwest currently has market risk sensitive instruments related to jet fuel prices and interest rates.

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel consumed in 1998 and 1997 represented approximately 11.2 and 15.0 percent of Southwest's operating expenses, respectively. Southwest endeavors to acquire jet fuel at the lowest prevailing prices possible.

The Company has historically hedged its exposure to jet fuel price market risk only on a conservative, limited basis. In December 1998, in order to take advantage of historically low jet fuel prices, Southwest increased its fuel hedging activity by entering into fixed price swap agreements hedging approximately 77 percent and 56 percent of its jet fuel needs in first and second quarter 1999, respectively. In January 1999, the Company increased its hedging position for second quarter 1999 to 74 percent. During 1999, the Company may continue its fuel hedging activities at these higher levels to take advantage of the historically low jet fuel prices.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

The fair values of outstanding fixed price swap agreements and purchased crude oil call options related to the Company's jet fuel price market risk at December 31, 1998 and 1997, and during the years then ended, were not material. A hypothetical ten percent increase or decrease in the underlying fuel related commodity prices from the December 31, 1998, prices would correspondingly change the fair value of these derivative commodity instruments and their related cash flows by approximately \$10 million.

Airline operators are also inherently capital intensive, as the vast majority of the Company's assets are aircraft, which are long lived. The Company's strategy is to capitalize itself conservatively and grow capacity steadily and profitably. While Southwest does use financial leverage, it has maintained a strong balance sheet and "A-" or equivalent credit ratings on its senior unsecured debt with three rating agencies (Standard & Poor's, Moody's, and Duff & Phelps).

As disclosed in Note 4 to the Consolidated Financial Statements, the Company had outstanding unsecured debt of \$500 million and \$600 million at December 31, 1998 and 1997, respectively, of which only \$500 million was long-term at December 31, 1997. This long-term debt represents only 12.1 percent and 14.5 percent of total noncurrent assets at December 31, 1998 and 1997, respectively. The Company currently has an average maturity of ten years for the long-term debt at fixed rates averaging 8.3 percent, which is comparable to average rates prevailing over the last ten years.

At December 31, 1998, the Company operated 112 aircraft under operating and capital leases at rates that are substantially fixed. As defined in Item 305, leases are not market risk sensitive financial instruments and, therefore, are not included in the interest rate sensitivity analysis below. Commitments related to leases are disclosed in Note 5 to the Consolidated Financial Statements.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

The Company does not have significant exposure to changing interest rates on its long-term debt because the interest rates are fixed and the financial leverage is modest. Additionally, the Company does not have significant exposure to changing interest rates on invested cash, which was \$379 million and \$623 million at December 31, 1998 and 1997, respectively. The Company invests available cash in certificates of deposit and investment grade commercial paper that have maturities of three months or less. As a result, the interest rate market risk implicit in these investments at December 31, 1998, is low, as the investments mature within three months. The Company has not undertaken any additional actions to cover interest rate market risk and is not a party to any other interest rate market risk management activities.

A hypothetical ten percent change in market interest rates over the next year would not impact the Company's earnings or cash flow as the interest rates on the Company's long-term debt are fixed and its cash investments are short-term. A ten percent change in market interest rates would not have a material effect on the fair value of the Company's publicly traded long-term debt or its short-term cash investments.

The Company does not purchase or hold any derivative financial instruments for trading purposes.

### **IMPACT OF THE YEAR 2000**

The Company is in the process of converting its computer systems to be Year 2000 ready. This project encompasses information technology systems as well as embedded technology assets. The project also includes an assessment of material third-party relationships and associated risks. The project as it relates to internal systems and equipment consists of four phases: identification, assessment, remediation, and testing. This project is expected to be substantially completed by June 30, 1999.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

*FLIGHT SAFETY SYSTEMS* The Company has completed all phases of its Year 2000 project as it relates to its aircraft fleet and onboard support systems. The Company has determined there are no safety issues with these systems.

The Company also utilizes ground computer systems and equipment essential for the maintenance of aircraft and the management of flight operations. The identification, assessment, and remediation phases of the project with respect to these systems and equipment are completed. The Company expects to complete testing by mid-1999.

*INTERNAL SYSTEMS* The Company's critical internal systems include computer hardware, software, and related equipment for customer reservations, ticketing, flight and crew scheduling, revenue management, accounting functions, and payroll, as well as airport activities including aircraft ground handling, bag handling, and security. The computing hardware and telecommunications equipment in the Company's central data center are essentially Year 2000 ready at this time. The majority of the Company's vital and critical software systems are either in testing or have already been made Year 2000 ready. While some systems are currently in the testing phase, with a small number in the remediation phase, the Company expects the majority of vital and critical systems to be Year 2000 ready by mid-1999.

*THIRD PARTIES* The Company has categorized its third party vendors with respect to their potential impact on Company operations in the event any such third party vendor has Year 2000 issues which are not dealt with on a timely basis. The Company is also identifying and assessing the impact of Year 2000 issues as they may affect the vendors' businesses (which, in turn, could affect the Company). The Company has made initial contacts with all of its material third party vendors and is in the process of evaluating their statements of Year 2000 compliance. In addition, the Company continues to work with other members of the Air Transport Association, the airline industry trade group, to share information and resources regarding vendors which are common to the entire industry.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

In management's experience, it is not always possible to obtain written certification of Year 2000 compliance from third party vendors. Accordingly, in such cases, the Company is basing its assessment on its own testing, other materials made available by such vendors, and other publicly available information. Upon the conclusion of such assessment, the Company will evaluate the need for contingency plans which may be needed in the event any such vendor cannot demonstrate to the Company, on a timely basis, its Year 2000 compliance.

The Company expects this evaluation and assessment will be an ongoing process through the balance of 1999.

*YEAR 2000 COSTS* The Company has expensed \$11.0 million (\$7.1 million in 1998) of costs incurred to date related to the Year 2000 issue. The total remaining cost of the Year 2000 project is presently estimated at approximately \$7 million, which will be expensed as incurred.

*RISK OF YEAR 2000 ISSUES* The Company believes its project to convert its computer systems to be Year 2000 ready will be completed in a timely manner and Year 2000 issues will not have a material adverse effect on operations. However, it is possible the Company's or third parties' systems and equipment could fail and result in the reduction or suspension of the Company's operations. The Company is currently in the process of developing contingency plans related to internal business critical systems and for those critical relationships with third parties. There can be no guarantee, however, that the Company's systems and equipment or third parties' systems and equipment on which Southwest relies will be Year 2000 ready in a timely manner or that contingency plans will mitigate the impact of any failure to complete plans in a timely manner.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

The costs of the project, the dates on which the Company believes it will complete the Year 2000 modifications and assessments, and the Company's analysis of its risk in this area are based on management's best estimates, which were derived utilizing numerous assumptions of future events, including the continued availability of certain resources. There can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Specific factors that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area and the ability to locate and correct all relevant computer code, as well as the cooperation needed from third party vendors and others upon whom the Company must rely.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### CONSOLIDATED BALANCE SHEET

(In thousands except share and per share amounts)	DECEMBER 31,	
	1998	1997
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$378,511	\$623,343
Accounts receivable	88,799	76,530
Inventories of parts and supplies, at cost	50,035	52,376
Deferred income taxes (Note 10)	20,734	18,843
Prepaid expenses and other current assets	<u>36,076</u>	<u>35,324</u>
Total current assets	574,155	806,416
Property and equipment, at cost (Notes 2 and 5):		
Flight equipment	4,709,059	3,987,493
Ground property and equipment	720,604	601,957
Deposits on flight equipment purchase contracts	<u>309,356</u>	<u>221,874</u>
	5,739,019	4,811,324
Less allowance for depreciation	<u>1,601,409</u>	<u>1,375,631</u>
	4,137,610	3,435,693
Other assets	<u>4,231</u>	<u>4,051</u>
	<b><u>\$4,715,996</u></b>	<b><u>\$4,246,160</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$157,415	\$160,891
Accrued liabilities (Note 3)	477,448	426,950
Air traffic liability	200,078	153,341
Current maturities of long-term debt (Note 4)	11,996	121,324
Other current liabilities	<u>3,716</u>	<u>6,007</u>
Total current liabilities	850,653	868,513
Long-term debt less current maturities (Note 4)	623,309	628,106
Deferred income taxes (Note 10)	549,207	438,981
Deferred gains from sale and leaseback of aircraft	238,412	256,255
Other deferred liabilities	56,497	45,287
Commitments and contingencies (Notes 2, 5, and 10)		
Stockholders' equity (Notes 7 and 8):		
Common stock, \$1.00 par value: 850,000,000 shares authorized; 335,904,306 and 221,207,083 shares issued in 1998 and 1997, respectively	335,904	221,207
Capital in excess of par value	89,820	155,696
Retained earnings	2,044,975	1,632,115
Treasury stock, at cost: 3,601,121 shares in 1998	<u>(72,781)</u>	-
Total stockholders' equity	<u>2,397,918</u>	<u>2,009,018</u>
	<b><u>\$4,715,996</u></b>	<b><u>\$4,246,160</u></b>

See accompanying notes.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### CONSOLIDATED STATEMENT OF INCOME

	YEARS ENDED DECEMBER 31,		
(In thousands except per share amounts)	1998	1997	1996
<b>Operating Revenues:</b>			
Passenger	\$3,963,781	\$3,639,193	\$3,269,238
Freight	98,500	94,758	80,005
Other	<u>101,699</u>	<u>82,870</u>	<u>56,927</u>
Total operating revenues	<b>4,163,980</b>	3,816,821	3,406,170
<b>Operating Expenses:</b>			
Salaries, wages, and benefits (Note 9)	1,285,942	1,136,542	999,719
Fuel and oil	388,348	494,952	484,673
Maintenance materials and repairs	302,431	256,501	253,521
Agency commissions	157,766	157,211	140,940
Aircraft rentals	202,160	201,954	190,663
Landing fees and other rentals	214,907	203,845	187,600
Depreciation	225,212	195,568	183,470
Other operating expenses	<u>703,603</u>	<u>646,012</u>	<u>614,749</u>
Total operating expenses	<b>3,480,369</b>	3,292,585	3,055,335
	<b>683,611</b>	524,236	350,835
<b>Operating Income</b>			
<b>Other expenses (Income):</b>			
Interest expense	56,276	63,454	59,269
Capitalized interest	(25,588)	(19,779)	(22,267)
Interest income	(31,083)	(36,616)	(25,797)
Nonoperating (gains) losses, net	<u>(21,106)</u>	<u>221</u>	<u>(1,732)</u>
Total other expenses (income)	<b>(21,501)</b>	7,280	9,473
<b>INCOME BEFORE INCOME TAXES</b>	<b>705,112</b>	516,956	341,362
<b>PROVISION FOR INCOME TAXES</b>			
<b>(NOTE 10)</b>	<b><u>271,681</u></b>	<u>199,184</u>	<u>134,025</u>
<b>NET INCOME</b>	<b><u>\$433,431</u></b>	<u>\$317,772</u>	<u>\$207,337</u>
<b>NET INCOME PER SHARE, BASIC (NOTES 7, 8, AND 11)</b>	<b><u>\$1.30</u></b>	<u>\$.97</u>	<u>\$.64</u>
<b>NET INCOME PER SHARE, DILUTED (NOTES 7, 8, AND 11)</b>	<b><u>\$1.23</u></b>	<u>\$.93</u>	<u>\$.61</u>

See accompanying notes.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

YEARS ENDED DECEMBER 31, 1998, 1997, and 1996

(In thousands except per share amounts)	Common Stock	Capital in Excess of Par Value	Retained Earnings	Treasury Stock	Total
Balance at December 31, 1995	\$144,033	\$162,704	\$1,120,581	\$ -	\$1,427,318
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 8)	1,079	14,513	-	-	15,592
Tax benefit of options exercised	-	4,433	-	-	4,433
Cash dividends, \$.0195 per share	-	-	(6,368)	-	(6,368)
Net income – 1996	-	-	<u>207,337</u>	-	<u>207,337</u>
Balance at December 31, 1996	145,112	181,650	1,321,550	-	1,648,312
Three-for-two stock split (Note 7)	73,578	(73,578)	-	-	-
Issuance of common stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 8)	2,517	37,818	-	-	40,335
Tax benefit of options exercised	-	9,806	-	-	9,806
Cash dividends, \$.0221 per share	-	-	(7,207)	-	(7,207)
Net income – 1997	-	-	<u>317,772</u>	-	<u>317,772</u>
Balance at December 31, 1997	221,207	155,696	1,632,115	-	2,009,018
<b>Three-for-two stock split (Note 7)</b>	<b>111,894</b>	<b>(111,894)</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Purchase of shares of treasury stock (Note 7)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>(100,000)</b>	<b>(100,000)</b>
<b>Issuance of common and treasury stock upon exercise of executive stock options and pursuant to Employee stock option and purchase plans (Note 8)</b>	<b>2,803</b>	<b>24,434</b>	<b>(10,184)</b>	<b>27,219</b>	<b>44,272</b>
<b>Tax benefit of options exercised</b>	<b>-</b>	<b>21,584</b>	<b>-</b>	<b>-</b>	<b>21,584</b>
<b>Cash dividends, \$.0283 per share</b>	<b>-</b>	<b>-</b>	<b>(10,387)</b>	<b>-</b>	<b>(10,387)</b>
<b>Net income – 1998</b>	<b>-</b>	<b>-</b>	<b><u>433,431</u></b>	<b>-</b>	<b><u>433,431</u></b>
<b>Balance at December 31, 1998</b>	<b><u>\$335,904</u></b>	<b><u>\$89,820</u></b>	<b><u>\$2,044,975</u></b>	<b><u>\$(72,781)</u></b>	<b><u>\$2,397,918</u></b>

See accompanying notes.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands)	YEARS ENDED DECEMBER 31,		
	1998	1997	1996
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$433,431	\$317,772	\$207,337
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	225,212	195,568	183,470
Deferred income taxes	108,335	81,711	67,253
Amortization of deferred gains on sale and leaseback of aircraft	(15,251)	(15,414)	(18,263)
Amortization of scheduled airframe overhauls	22,763	20,540	20,539
Changes in certain assets and liabilities:			
Accounts receivable	(12,269)	(3,090)	6,341
Other current assets	1,589	6,243	(19,534)
Accounts payable and accrued liabilities	53,194	8,751	132,096
Air traffic liability	46,737	(4,757)	26,942
Other current liabilities	19,293	(4,204)	5,334
Other	3,101	7,468	3,713
Net cash provided by operating activities	<u>886,135</u>	610,588	615,228
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchases of property and equipment	<u>(947,096)</u>	<u>(688,927)</u>	<u>(677,431)</u>
Net cash used in investing activities	<u>(947,096)</u>	<u>(688,927)</u>	<u>(677,431)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Issuance of long-term debt	-	98,764	-
Proceeds from aircraft sale and leaseback transactions	-	-	330,000
Payment of long-term debt and capital lease obligations	(118,859)	(12,665)	(12,695)
Payment of cash dividends	(9,284)	(6,593)	(6,216)
Proceeds from Employee stock plans	44,272	40,335	15,592
Repurchase of common stock	<u>(100,000)</u>	-	-
Net cash provided by (used in) financing activities	<u>(183,871)</u>	<u>119,841</u>	<u>326,681</u>
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>(244,832)</b>	41,502	264,478
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b><u>623,343</u></b>	<b><u>581,841</u></b>	<b><u>317,363</u></b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b><u>\$378,511</u></b>	<b><u>\$623,343</u></b>	<b><u>\$581,841</u></b>
<b>CASH PAYMENTS FOR:</b>			
Interest, net of amount capitalized	\$33,384	\$42,372	\$36,640
Income taxes	147,447	107,066	66,447

See accompanying notes.

# SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 1998

### 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*BASIS OF PRESENTATION* Southwest Airlines Co. (Southwest) is a major domestic airline that provides shorthaul, high-frequency, point-to-point, low-fare service. The consolidated financial statements include the accounts of Southwest and its wholly owned subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates. Certain prior year amounts have been reclassified for comparison purposes.

*CASH AND CASH EQUIVALENTS* Cash equivalents consist of certificates of deposit and investment grade commercial paper issued by major corporations and financial institutions that are highly liquid and have original maturities of three months or less. Cash and cash equivalents are carried at cost, which approximates market value.

*INVENTORIES* Inventories of flight equipment expendable parts, materials, and supplies are carried at average cost. These items are charged to expense when issued for use.

*PROPERTY AND EQUIPMENT* Depreciation is provided by the straight-line method to estimated residual values over periods ranging from 20 to 25 years for flight equipment and 3 to 30 years for ground property and equipment. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the Company's incremental borrowing rate or, when known, the interest rate implicit in the lease. Amortization of property under capital leases is on a straight-line basis over the lease term and is included in depreciation expense. The Company records impairment losses on long-lived assets used in operations when events and circumstances indicate that the assets might be impaired and the undiscounted cash flows to be generated by those assets are less than the carrying amounts of those assets.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

***AIRCRAFT AND ENGINE MAINTENANCE*** The cost of engine overhauls and routine maintenance costs for aircraft and engines are charged to maintenance expense as incurred. Scheduled airframe overhaul costs are capitalized and amortized over the estimated period benefited, presently the lesser of ten years or the remaining life of the aircraft. Modifications that significantly enhance the operating performance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

***REVENUE RECOGNITION*** Passenger revenue is recognized when transportation is provided. Tickets sold but not yet used are included in "Air traffic liability," which includes estimates that are evaluated and adjusted periodically. Any adjustments resulting therefrom are included in results of operations for the periods in which the evaluations are completed.

***FREQUENT FLYER PROGRAM*** The Company accrues the estimated incremental cost of providing free travel awards earned under its Rapid Rewards frequent flyer program. The Company also sells flight segment credits to companies participating in its Rapid Rewards frequent flyer program. The revenue from the sale of flight segment credits is recognized when the credits are sold.

***ADVERTISING*** The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 1998, 1997, and 1996 was \$119,739,000, \$112,961,000, and \$109,136,000, respectively.

***STOCK-BASED EMPLOYEE COMPENSATION*** Pursuant to Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation*, the Company accounts for stock-based compensation plans utilizing the provisions of Accounting Principles Board Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees and related Interpretations*.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

*DERIVATIVE FINANCIAL INSTRUMENTS* The Company utilizes purchased crude oil call options and fixed price swap agreements to hedge a portion of its exposure to fuel price fluctuations. The cost of purchased crude oil call options and gains and losses on fixed price swap agreements are deferred and charged or credited to fuel expense in the same month that the underlying fuel being hedged is used. Gains and losses resulting from hedging positions terminated or settled early are recorded to fuel expense in the month of termination or settlement. Gains and losses on hedging transactions have not been material.

In 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, which is required to be adopted in years beginning after June 15, 1999. SFAS 133 permits early adoption as of the beginning of any fiscal quarter after its issuance. The Company expects to adopt the new Statement effective January 1, 2000. SFAS 133 will require the Company to recognize all derivatives on the balance sheet at fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has not yet determined what the effect of SFAS 133 will be on the earnings and financial position of the Company.

## 2. COMMITMENTS

The Company's contractual purchase commitments consist primarily of scheduled aircraft acquisitions. Thirty-two 737-700 aircraft are scheduled for delivery in 1999, 21 in 2000, 21 in 2001, 21 in 2002, five in 2003, and five in 2004. In addition, the Company has options to purchase up to 62 -700s during 2003–2006. The Company has the option, which must be exercised two years prior to the contractual delivery date, to substitute 737-600s or 737-800s for the -700s scheduled subsequent to 2000. Aggregate funding needed for firm commitments is approximately \$2,492.5 million, subject to adjustments for inflation, due as follows: \$715.9 million in 1999,

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

\$520.2 million in 2000, \$498.7 million in 2001, \$515.8 million in 2002, \$152.8 million in 2003, and \$89.1 million in 2004.

### 3. ACCRUED LIABILITIES

(In thousands)	1998	1997
Employee profitsharing and savings plans (Note 9)	<b>\$123,195</b>	\$92,857
Aircraft rentals	<b>121,868</b>	123,669
Vacation pay	<b>54,781</b>	50,812
Other	<b><u>177,604</u></b>	<u>159,612</u>
	<b><u>\$477,448</u></b>	<u>\$426,950</u>

### 4. LONG-TERM DEBT

(In thousands)	1998	1997
9 1/4% Notes due 1998	\$ -	\$100,000
9.4% Notes due 2001	<b>100,000</b>	100,000
8 3/4% Notes due 2003	<b>100,000</b>	100,000
8% Notes due 2005	<b>100,000</b>	100,000
7 7/8% Notes due 2007	<b>100,000</b>	100,000
7 3/8% Debentures due 2027	<b>100,000</b>	100,000
Capital leases (Note 5)	<b>133,190</b>	152,324
Other	<b><u>4,481</u></b>	-
	<b>637,671</b>	752,324
Less current maturities	<b>11,996</b>	121,324
Less debt discount	<b><u>2,366</u></b>	<u>2,894</u>
	<b><u>\$623,309</u></b>	<u>\$628,106</u>

On February 28, 1997, the Company issued \$100 million of senior unsecured 7 3/8% Debentures due March 1, 2027. Interest is payable semi-annually on March 1 and September 1. The Debentures may be redeemed, at the option of the Company, in whole at any time or in part from time to time, at a redemption price equal to the greater of the principal amount of the Debentures plus accrued interest at the date of redemption or the sum of the present values of the remaining scheduled payments of principal and interest thereon, discounted to the date of redemption at the comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

On March 7, 1995, the Company issued \$100 million of senior unsecured 8% Notes due March 1, 2005. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

On September 9, 1992, the Company issued \$100 million of senior unsecured 7 7/8% Notes due September 1, 2007. Interest is payable semi-annually on March 1 and September 1. The Notes are not redeemable prior to maturity.

During 1991, the Company issued \$100 million of senior unsecured 9 1/4% Notes, \$100 million of senior unsecured 9.4% Notes, and \$100 million of senior unsecured 8 3/4% Notes due February 15, 1998, July 1, 2001, and October 15, 2003, respectively. Interest on the Notes is payable semi-annually. The 9 1/4% Notes due February 15, 1998, were paid in full upon maturity. The remaining Notes are not redeemable prior to maturity.

In addition to the credit facilities described above, Southwest has an unsecured Bank Credit Agreement with a group of banks that permits Southwest to borrow through May 6, 2002, on a revolving credit basis, up to \$475 million. Interest rates on borrowings under the Credit Agreement can be, at the option of Southwest, the greater of the agent bank's prime rate or the federal funds rate plus .5 percent, .17 percent over LIBOR, or a fixed rate offered by the banks at the time of borrowing. The commitment fee is .08 percent per annum. There were no outstanding borrowings under this agreement, or prior similar agreements, at December 31, 1998 or 1997.

### **5. LEASES**

Total rental expense for operating leases charged to operations in 1998, 1997, and 1996 was \$306,629,000, \$297,158,000, and \$280,389,000, respectively. The majority of the Company's terminal operations space, as well as 99 aircraft, were under operating leases at December 31, 1998. The amounts applicable to capital leases included in property and equipment were:

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

(In thousands)	<b>1998</b>	1997
Flight equipment	<b>\$230,486</b>	\$227,803
Less accumulated amortization	<b><u>133,073</u></b>	<u>122,346</u>
	<b><u>\$97,413</u></b>	<u>\$105,457</u>

Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 1998, were:

(In thousands)	Capital Leases	Operating Leases
1999	\$20,245	\$247,208
2000	16,871	235,955
2001	17,391	222,688
2002	17,561	208,311
2003	17,750	190,925
After 2003	<u>120,049</u>	<u>1,901,005</u>
Total minimum lease payments	209,867	<u>\$3,006,092</u>
Less amount representing interest	<u>76,677</u>	
Present value of minimum lease payments	133,190	
Less current portion	<u>9,400</u>	
Long-term portion	<u>\$123,790</u>	

The aircraft leases generally can be renewed, at rates based on fair market value at the end of the lease term, for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, but generally not to exceed a stated percentage of the lessor's defined cost of the aircraft.

### 6. FINANCIAL INSTRUMENTS

The Company utilizes purchased crude oil call options and fixed price swap agreements to hedge a portion of its exposure to fuel price fluctuations. Prior to December 1998, outstanding call options and swap agreements were not material. At December 31, 1998, the Company had hedged its exposure to fuel price fluctuations on approximately 77 percent of its first quarter 1999 and 56 percent of its second quarter 1999 anticipated fuel requirements, or 290 million gallons of fuel products. The fair

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

value of these agreements at December 31, 1998, representing the amount the Company would receive if the agreements were settled early, was not material.

Any outstanding call options or fixed swap agreements expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements, but the Company does not expect any of the counterparties to fail to meet its obligations. The credit exposure related to these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risks, the Company selects counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 1998, the Company had no collateral or other security interests supporting these agreements but was in the process of negotiating such agreements with a majority of the counterparties.

The Company does not hold or issue any financial instruments for trading purposes.

The fair values of the Company's long-term debt were based on quoted market prices. The carrying amounts and estimated fair values of the Company's long-term debt at December 31, 1998, were as follows:

(In thousands)	Carrying Value	Fair Value
9.4% Notes due 2001	\$100,000	\$108,929
8 3/4% Notes due 2003	100,000	112,702
8% Notes due 2005	100,000	109,648
7 7/8% Notes due 2007	100,000	111,390
7 3/8% Debentures due 2027	100,000	106,657

The carrying values of all other financial instruments approximate their fair value.

### 7. COMMON STOCK

The Company has one class of common stock. Holders of shares of common stock are entitled to receive dividends when and if declared by the Board of Directors and are entitled to one vote per share on all matters submitted to a vote of the shareholders.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

At December 31, 1998, the Company had common stock reserved for issuance pursuant to Employee stock benefit plans (69,453,206 shares) and upon exercise of rights (405,357,512 shares) pursuant to the Common Stock Rights Agreement, as amended (Agreement).

Pursuant to the Agreement, each outstanding share of the Company's common stock is accompanied by one common share purchase right (Right). Each Right entitles its holder to purchase one share of common stock at an exercise price of \$7.41 and is exercisable only in the event of a proposed takeover, as defined by the Agreement. The Company may redeem the Rights at \$.0049 per Right prior to the time that 15 percent of the common stock has been acquired by a person or group. If the Company is acquired, as defined in the Agreement, each Right will entitle its holder to purchase for \$7.41 that number of the acquiring company's or the Company's common shares, as provided in the Agreement, having a market value of two times the exercise price of the Right. The Rights will expire no later than July 30, 2006.

On September 25, 1997, the Company's Board of Directors declared a three-for-two stock split, distributing 73,577,983 shares on November 26, 1997. On July 22, 1998, the Company's Board of Directors declared a three-for-two stock split, distributing 111,894,315 shares on August 20, 1998. Unless otherwise stated, all per share data presented in the accompanying consolidated financial statements and notes thereto have been restated to give effect to the stock splits.

As of July 22, 1998, the Company's Board of Directors increased the Company's authorization to repurchase shares of its outstanding common stock to \$100 million. The Company completed this repurchase program during third quarter 1998, resulting in the repurchase of 4,885,763 shares at an average cost of \$20.47 per share. All of the acquired shares are held as common stock in treasury, less shares reissued under the Employee stock option and purchase plans. When treasury shares are reissued, the Company uses a first-in, first-out method and the excess of repurchase cost over reissuance price, if any, is treated as a reduction of retained earnings.

## **8. STOCK PLANS**

At December 31, 1998, the Company had seven stock-based compensation plans and other stock options outstanding, which are described below. The Company applies APB 25 and related Interpretations in accounting for its stock-based compensation. Accordingly, no compensation expense is recognized for its fixed option plans because the exercise prices of the Company's Employee stock options equal or exceed the market prices of the underlying stock on the dates of the grants. Compensation expense for other stock options is not material.

The Company has six fixed option plans. Under the 1991 Incentive Stock Option Plan, the Company may grant options to key Employees for up to 20,250,000 shares of common stock. Under the 1991 Non-Qualified Stock Option Plan, the Company may grant options to key Employees and non-employee directors for up to 1,687,500 shares of common stock. All options granted under these plans have ten-year terms and vest and become fully exercisable at the end of three, five, or ten years of continued employment, depending upon the grant type.

Under the 1995 Southwest Airlines Pilots' Association Non-Qualified Stock Option Plan (SWAPA Plan), the Company may grant options to Pilots for up to 40,500,000 shares of common stock. An initial grant of approximately 32,788,000 shares was made on January 12, 1995, at an option price of \$8.89 per share, which exceeded the market price of the Company's stock on that date. Options granted under the initial grant vest in ten annual increments of ten percent. On September 1 of each year of the agreement beginning in 1996, additional options will be granted to Pilots that become eligible during that year. Additional options granted on September 1, 1998, 1997, and 1996, vest in six annual increments of 16.7 percent, seven annual increments of 14.3 percent, and eight annual increments of 12.5 percent, respectively. Options under all grants must be exercised prior to January 31, 2007, or within a specified time upon retirement or termination.

Under the 1996 Incentive Stock Option Plan, the Company may grant options to key Employees for up to 13,500,000 shares of common stock. Under the 1996 Non-Qualified Stock Option Plan, the Company may grant options to key Employees and non-employee directors for up to 1,293,750 shares of common stock. All options

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

granted under these plans have ten-year terms and vest and become fully exercisable at the end of three, five, or ten years of continued employment, depending upon the grant type.

Under the 1998 Southwest Airlines Employee Association Non-Qualified Stock Option Plan (SAEA Plan), the Company may grant options to Dispatchers for up to 1,050,000 shares of common stock. An initial grant of 738,000 shares was made on September 10, 1998, at an option price of \$19.62 per share, which exceeded the market price of the Company's stock on that date. Options granted under the initial grant vest in annual increments of varying percentages, depending on seniority level, through 2006. On December 1 of each year of the agreement beginning in 1998 and through December 1, 2008, additional options will be granted to Dispatchers that become eligible during that year. No options were granted on December 1, 1998. Options under all grants must be exercised prior to June 30, 2012, or within a specified time upon retirement or termination.

Under all fixed option plans, except the SWAPA and SAEA Plans, the exercise price of each option equals the market price of the Company's stock on the date of grant. Under the SWAPA and SAEA Plans, for additional options granted each September 1 and December 1, respectively, the exercise price will be equal to 105 percent of the fair value of such stock on the date of the grant.

Information regarding the Company's six fixed stock option plans, as adjusted for stock splits, is summarized below:

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

	INCENTIVE PLANS		NON-QUALIFIED PLANS	
	OPTIONS	AVERAGE EXERCISE PRICE	OPTIONS	AVERAGE EXERCISE PRICE
Outstanding December 31, 1995	11,726,729	\$5.99	33,421,656	\$8.83
Granted – Incentive Plans	3,758,274	11.19	-	-
Granted – SWAPA Plan	-	-	1,048,950	10.59
Granted – Other Non-Qualified Plans	-	-	155,525	11.19
Exercised	(890,658)	4.57	(653,367)	7.95
Surrendered	<u>(563,504)</u>	8.96	<u>(213,716)</u>	8.89
Outstanding December 31, 1996	14,030,841	7.35	33,759,048	8.91
Granted – Incentive Plans	3,682,737	9.67	-	-
Granted – SWAPA Plan	-	-	1,323,000	13.19
Granted – Other Non-Qualified Plans	-	-	218,109	9.67
Exercised	(1,727,889)	6.03	(2,657,746)	8.85
Surrendered	<u>(1,005,019)</u>	9.72	<u>(148,818)</u>	9.06
Outstanding December 31, 1997	14,980,670	7.91	32,493,593	9.09
<b>Granted – Incentive Plans</b>	<b><u>2,738,597</u></b>	<b><u>17.72</u></b>	<b>-</b>	<b>-</b>
<b>Granted – SWAPA Plan</b>	<b>-</b>	<b>-</b>	<b>902,475</b>	<b>19.36</b>
<b>Granted – SAEA Plan</b>	<b>-</b>	<b>-</b>	<b>738,013</b>	<b>19.62</b>
<b>Granted – Other Non-Qualified Plans</b>	<b>-</b>	<b>-</b>	<b>256,191</b>	<b>17.69</b>
<b>Exercised</b>	<b><u>(2,360,733)</u></b>	<b>6.27</b>	<b><u>(2,521,455)</u></b>	<b>9.07</b>
<b>Surrendered</b>	<b><u>(834,289)</u></b>	<b>10.52</b>	<b><u>(247,252)</u></b>	<b>9.95</b>
<b>Outstanding December 31, 1998</b>	<b><u>14,524,245</u></b>	<b><u>\$9.89</u></b>	<b><u>31,621,565</u></b>	<b><u>\$9.69</u></b>
<b>Exercisable December 31, 1998</b>	<b>3,132,557</b>		<b>12,271,309</b>	
<b>Available for granting in future periods</b>	<b>11,995,971</b>		<b>6,768,712</b>	

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

The following table summarizes information about stock options outstanding under the six fixed option plans at December 31, 1998:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER OUTSTANDING AT 12/31/98	WEIGHTED-AVERAGE REMAINING CONTRACTUAL LIFE	WEIGHTED-AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE AT 12/31/98	WEIGHTED-AVERAGE EXERCISE PRICE
\$2.68 to \$3.47	3,307,850	2.03 yrs	\$2.74	1,195,748	\$2.86
\$5.04 to \$7.50	485,476	3.07	5.35	141,557	5.36
\$8.36 to \$10.83	32,844,404	7.85	8.97	12,009,216	8.94
\$11.19 to \$16.64	5,061,066	6.85	12.23	1,472,115	12.99
\$17.71 to \$19.62	<u>4,447,014</u>	9.59	18.37	<u>585,230</u>	18.57
\$2.68 to \$19.62	<u>46,145,810</u>	7.44 yrs	\$9.75	<u>15,403,866</u>	\$9.19

The Company has granted options to purchase the Company's common stock related to employment contracts with the Company's president and chief executive officer. Depending upon the grant, these options have terms of ten years from the date of grant or ten years from the date exercisable and vest and become fully exercisable over three or four years. No options were granted in 1998 or 1997. In 1996, the Company granted 325,000 options with an exercise price of \$1.00 per share and 1,125,000 options with an exercise price of \$10.44 per share related to the 1996 employment agreement. At December 31, 1998, 1997, and 1996, total options of 3,688,000, 3,916,000, and 4,270,000 were outstanding, respectively. At December 31, 1998, total options of 3,108,000 were exercisable at exercise prices ranging from \$1.00 to \$10.44 per share. Options for 228,000, 354,000, and 379,500 shares were exercised in 1998, 1997, and 1996, respectively.

Under the 1991 Employee Stock Purchase Plan (ESPP), at December 31, 1998, the Company is authorized to issue up to a balance of 855,000 shares of common stock to Employees of the Company at a price equal to 90 percent of the market value at the end of each purchase period. Common stock purchases are paid for through periodic payroll deductions. Participants under the plan received 451,000 shares in 1998, 660,000 shares in 1997, and 696,000 shares in 1996 at average prices of \$17.45, \$10.67, and \$10.25, respectively.

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Pro forma information regarding net income and net income per share is required by SFAS 123 and has been determined as if the Company had accounted for its Employee stock-based compensation plans and other stock options under the fair value method of SFAS 123. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions used for grants under the fixed option plans in 1998, 1997, and 1996, respectively: dividend yield of .16 percent, .22 percent, and .16 percent; expected volatility of 38.20 percent, 38.23 percent, and 35.37 percent; risk-free interest rate of 4.66 percent, 5.80 percent, and 5.89 percent; and expected lives of 5.0 years for all periods. Assumptions for the stock options granted in 1996 to the Company's president and chief executive officer were the same as for the fixed option plans except for the weighted-average expected lives of 8.0 years.

The weighted-average fair value of options granted under the fixed option plans, except the SAEA Plan, during 1998, 1997, and 1996 was \$7.17, \$4.08, and \$4.52, respectively, for the incentive plans; \$7.14, \$5.11, and \$4.11, respectively, for the SWAPA Plan; and \$7.15, \$4.08, and \$4.52, respectively, for other non-qualified plans. The weighted-average fair value of options granted in 1998 under the SAEA Plan was \$7.25. The weighted-average fair value of options granted in 1996 to the Company's president and chief executive officer relative to an employment contract was \$6.21. No such options were granted in 1998 or 1997. The weighted-average fair value of each purchase right under the ESPP granted in 1998, 1997, and 1996, which is equal to the ten percent discount from the market value of the common stock at the end of each purchase period, was \$1.94, \$1.19, and \$1.14, respectively.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including expected stock price volatility. Because the Company's Employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its Employee stock options.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

For purposes of pro forma disclosures, the estimated fair value of stock-based compensation plans and other options is amortized to expense primarily over the vesting period. The Company's pro forma net income and net income per share is as follows:

(In thousands except per share amounts)	1998	1997	1996
<b>NET INCOME:</b>			
As reported	<b>\$433,431</b>	\$317,772	\$207,337
Pro forma	<b>\$421,097</b>	\$306,553	\$196,478
<b>NET INCOME PER SHARE, BASIC:</b>			
As reported	<b>\$1.30</b>	\$.97	\$.64
Pro forma	<b>\$1.26</b>	\$.93	\$.60
<b>NET INCOME PER SHARE, DILUTED:</b>			
As reported	<b>\$1.23</b>	\$.93	\$.61
Pro forma	<b>\$1.20</b>	\$.90	\$.60

As required, the pro forma disclosures above include only options granted since January 1, 1995. Consequently, the effects of applying SFAS 123 for providing pro forma disclosures may not be representative of the effects on reported net income for future years until all options outstanding are included in the pro forma disclosures.

### 9. EMPLOYEE PROFITSHARING AND SAVINGS PLANS

Substantially all of Southwest's Employees are members of the Southwest Airlines Co. Profitsharing Plan. Total profitsharing expense charged to operations in 1998, 1997, and 1996 was \$120,697,000, \$91,256,000, and \$59,927,000, respectively.

The Company sponsors Employee savings plans under Section 401(k) of the Internal Revenue Code. The plans cover substantially all full-time Employees. The amount of matching contributions varies by Employee group. Company contributions generally vest over five years with credit for prior years' service granted. Company matching contributions expensed in 1998, 1997, and 1996 were \$46,415,000, \$39,744,000, and \$35,125,000, respectively.

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### 10. INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred tax assets and liabilities at December 31, 1998 and 1997 are as follows:

(In thousands)	1998	1997
<b>DEFERRED TAX LIABILITIES:</b>		
Accelerated depreciation	<b>\$641,673</b>	\$543,547
Scheduled airframe maintenance	<b>40,073</b>	33,202
Other	<b><u>95,485</u></b>	<u>83,607</u>
Total deferred tax liabilities	<b><u>777,231</u></b>	660,356
<b>DEFERRED TAX ASSETS:</b>		
Deferred gains from sale and leaseback of aircraft	<b>107,157</b>	112,659
Capital and operating leases	<b>61,275</b>	61,747
Other	<b><u>80,326</u></b>	<u>65,812</u>
Total deferred tax assets	<b><u>248,758</u></b>	<u>240,218</u>
Net deferred tax liability	<b><u>\$528,473</u></b>	<u>\$420,138</u>

The provision for income taxes is composed of the following:

(In thousands)	1998	1997	1996
<b>CURRENT:</b>			
Federal	<b>\$143,989</b>	\$102,938	\$59,101
State	<b><u>19,357</u></b>	<u>14,535</u>	<u>7,671</u>
Total current	<b>163,346</b>	117,473	66,772
<b>DEFERRED:</b>			
Federal	<b>96,237</b>	75,990	60,967
State	<b><u>12,098</u></b>	<u>5,721</u>	<u>6,286</u>
Total deferred	<b><u>108,335</u></b>	<u>81,711</u>	<u>67,253</u>
	<b><u>\$271,681</u></b>	<u>\$199,184</u>	<u>\$134,025</u>

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

The Company received a statutory notice of deficiency from the Internal Revenue Service (IRS) in July 1995 in which the IRS proposed to disallow deductions claimed by the Company on its federal income tax returns for the taxable years 1989 through 1991 for the costs of certain aircraft inspection and maintenance procedures. The IRS has proposed similar adjustments to the tax returns of numerous other members of the airline industry. In response to the statutory notice of deficiency, the Company filed a petition in the United States Tax Court on October 30, 1997, seeking a determination that the IRS erred in disallowing the deductions claimed by the Company and that there is no deficiency in the Company's tax liability for the taxable years in issue. It is expected that the Tax Court's decision will not be entered for several years. Management believes the final resolution of this controversy will not have a material adverse effect upon the results of operations of the Company.

The effective tax rate on income before income taxes differed from the federal income tax statutory rate for the following reasons:

(In thousands)	<b>1998</b>	1997	1996
Tax at statutory			
U.S. tax rates	<b>\$246,789</b>	\$180,935	\$119,477
Nondeductible items	<b>5,099</b>	5,893	5,168
State income taxes, net of federal benefit	<b>20,445</b>	13,166	9,072
Other, net	<b><u>(652)</u></b>	<u>(810)</u>	<u>308</u>
Total income			
tax provision	<b><u>\$271,681</u></b>	<u>\$199,184</u>	<u>\$134,025</u>

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### 11. NET INCOME PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

(In thousands except per share amounts)	<b>1998</b>	1997	1996
<b>NUMERATOR:</b>			
Net income, available to common stockholders — numerator for basic and diluted earnings per share	<u><b>\$433.431</b></u>	<u>\$317.772</u>	<u>\$207.337</u>
<b>DENOMINATOR:</b>			
Weighted-average shares outstanding, basic	<b>333,342</b>	328,631	325,676
Dilutive effect of Employee stock options	<u><b>19,824</b></u>	<u>12,557</u>	<u>11,810</u>
Adjusted weighted-average shares outstanding, diluted	<u><b>353.166</b></u>	<u>341.188</u>	<u>337.486</u>
<b>NET INCOME PER SHARE:</b>			
Basic	<u><b>\$1.30</b></u>	<u>\$ .97</u>	<u>\$ .64</u>
Diluted	<u><b>\$1.23</b></u>	<u>\$ .93</u>	<u>\$ .61</u>

# **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

## **REPORT OF ERNST & YOUNG LLP INDEPENDENT AUDITORS**

### **THE BOARD OF DIRECTORS AND SHAREHOLDERS SOUTHWEST AIRLINES CO.**

We have audited the accompanying consolidated balance sheets of Southwest Airlines Co. as of December 31, 1998 and 1997, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Airlines Co. at December 31, 1998 and 1997, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

### **ERNST & YOUNG, LLP**

Dallas, Texas

January 20, 1999

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### QUARTERLY FINANCIAL DATA (UNAUDITED)

(In thousands except per share amounts)	THREE MONTHS ENDED			
	MARCH 31	JUNE 30	SEPT. 30	DEC. 31
<b>1998</b>				
<b>Operating revenues</b>	<b>\$942,653</b>	<b>\$1,078,841</b>	<b>\$1,094,830</b>	<b>\$1,047,656</b>
<b>Operating income</b>	<b>111,693</b>	<b>208,548</b>	<b>203,919</b>	<b>159,451</b>
<b>Income before income taxes</b>	<b>114,057</b>	<b>216,547</b>	<b>211,055</b>	<b>163,453</b>
<b>Net income</b>	<b>70,008</b>	<b>133,393</b>	<b>129,645</b>	<b>100,385</b>
<b>Net income per share, basic</b>	<b>.21</b>	<b>.40</b>	<b>.39</b>	<b>.30</b>
<b>Net income per share, diluted</b>	<b>.20</b>	<b>.38</b>	<b>.37</b>	<b>.29</b>
<b>1997</b>				
Operating revenues	\$887,095	\$956,892	\$997,241	\$975,593
Operating income	87,203	156,407	151,770	128,856
Income before income taxes	83,401	153,823	150,387	129,345
Net income	50,874	93,832	92,511	80,555
Net income per share, basic	.16	.29	.28	.24
Net income per share, diluted	.15	.28	.27	.23

### COMMON STOCK PRICE RANGES AND DIVIDENDS

Southwest's common stock is listed on the New York Stock Exchange and is traded under the symbol LUV. The high and low sales prices of the common stock on the Composite Tape and the quarterly dividends per share, as adjusted for the November 1997 and July 1998 three-for-two stock splits, were:

PERIOD	DIVIDENDS	HIGH	LOW
<b>1998</b>			
<b>1st Quarter</b>	<b>\$.00667</b>	<b>\$21.42</b>	<b>\$15.33</b>
<b>2nd Quarter</b>	<b>.00667</b>	<b>20.71</b>	<b>16.83</b>
<b>3rd Quarter</b>	<b>.00750</b>	<b>23.38</b>	<b>17.19</b>
<b>4th Quarter</b>	<b>.00750</b>	<b>23.75</b>	<b>15.31</b>
<b>1997</b>			
1st Quarter	\$.00513	\$11.11	\$9.45
2nd Quarter	.00513	12.45	9.55
3rd Quarter	.00513	14.75	11.55
4th Quarter	.00667	17.50	12.55

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

### TEN-YEAR SUMMARY

#### SELECTED CONSOLIDATED FINANCIAL DATA

(1)

(In thousands except per share amounts)

	1998	1997	1996	1995
Operating revenues:				
Passenger	<b>\$3,963,781</b>	\$3,639,193	\$3,269,238	\$2,760,756
Freight	<b>98,500</b>	94,758	80,005	65,825
Other	<b>101,699</b>	82,870	56,927	46,170
Total operating revenues	<b>4,163,980</b>	3,816,821	3,406,170	2,872,751
Operating expenses	<b>3,480,369</b>	3,292,585	3,055,335	2,559,220
Operating income	<b>683,611</b>	524,236	350,835	313,531
Other expenses (income), net	<b>(21,501)</b>	7,280	9,473	8,391
Income before income taxes	<b>705,112</b>	516,956	341,362	305,140
Provision for income taxes (3)	<b>271,681</b>	199,184	134,025	122,514
Net income (3)	<b>\$433,431</b>	<b>\$317,772</b>	<b>\$207,337</b>	<b>\$182,626</b>
Net income per share, basic (3)	<b>\$1.30</b>	\$.97	\$.64	\$.56
Net income per share, diluted (3)	<b>\$1.23</b>	\$.93	\$.61	\$.55
Cash dividends per common share	<b>\$0.02834</b>	\$.02206	\$.01955	\$.01778
Total assets	<b>\$4,715,996</b>	\$4,246,160	\$3,723,479	\$3,256,122
Long-term debt	<b>\$623,309</b>	\$628,106	\$650,226	\$661,010
Stockholders' equity	<b>\$2,397,918</b>	\$2,009,018	\$1,648,312	\$1,427,318

#### CONSOLIDATED FINANCIAL RATIOS (1)

Return on average total assets	<b>9.7 %</b>	8.0 %	5.9 %	6.0 %
Return on average stockholders' equity	<b>19.7 %</b>	17.4 %	13.5 %	13.7 %

#### CONSOLIDATED OPERATING STATISTICS (2)

Revenue passengers carried	<b>52,586,400</b>	50,399,960	49,621,504	44,785,573
RPMs (000s)	<b>31,419,110</b>	28,355,169	27,083,483	23,327,804
ASMs (000s)	<b>47,543,515</b>	44,487,496	40,727,495	36,180,001
Passenger load factor	<b>66.1%</b>	63.7%	66.5%	64.5%
Average length of passenger haul	<b>597</b>	563	546	521
Trips flown	<b>806,822</b>	786,288	748,634	685,524
Average passenger fare	<b>\$75.38</b>	\$72.21	\$65.88	\$61.64
Passenger revenue yield per RPM	<b>12.62¢</b>	12.84¢	12.07¢	11.83¢
Operating revenue yield per ASM	<b>8.76¢</b>	8.58¢	8.36¢	7.94¢
Operating expenses per ASM	<b>7.32¢</b>	7.40¢	7.50¢	7.07¢
Fuel cost per gallon (average)	<b>45.67¢</b>	62.46¢	65.47¢	55.22¢
Number of Employees at yearend	<b>25,844</b>	23,974	22,944	19,933
Size of fleet at yearend (10)	<b>280</b>	261	243	224

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

1994	1993	1992	1991	1990	1989
\$2,497,765	\$2,216,342	\$1,623,828	\$1,267,897	\$1,144,421	\$973,568
54,419	42,897	33,088	26,428	22,196	18,771
<u>39,749</u>	<u>37,434</u>	<u>146,063</u>	<u>84,961</u>	<u>70,659</u>	<u>65,390</u>
2,591,933	2,296,673	1,802,979	1,379,286	1,237,276	1,057,729
<u>2,275,224</u>	<u>2,004,700</u>	<u>1,609,175</u>	<u>1,306,675</u>	<u>1,150,015</u>	<u>955,689</u>
316,709	291,973	193,804	72,611	87,261	102,040
<u>17,186</u>	<u>32,336</u>	<u>36,361</u>	<u>18,725</u>	<u>6,827 (6)</u>	<u>(13,696) (7)</u>
299,523	259,637	157,443	53,886	80,434	115,736
<u>120,192</u>	<u>105,353</u>	<u>60,058</u>	<u>20,738</u>	<u>29,829</u>	<u>41,231</u>
<u>\$179,331</u>	<u>\$154,284 (4)</u>	<u>\$97,385 (5)</u>	<u>\$33,148</u>	<u>\$50,605</u>	<u>\$74,505</u>
\$ .56	\$ .48 (4)	\$ .31 (5)	\$ .11	\$ .17	\$ .24
\$ .54	\$ .47 (4)	\$ .30 (5)	\$ .11	\$ .17	\$ .24
\$ .01778	\$ .01719	\$ .01570	\$ .01481	\$ .01433	\$ .01382
\$2,823,071	\$2,576,037	\$2,368,856	\$1,854,331	\$1,480,813	\$1,423,298
\$583,071	\$639,136	\$735,754	\$617,434	\$327,553	\$354,150
\$1,238,706	\$1,054,019	\$879,536	\$635,793	\$607,294	\$591,794
6.6 %	6.2 % (4)	4.6 % (5)	2.0 %	3.5 %	5.5 %
15.6 %	16.0 % (4)	12.9 % (5)	5.3 %	8.4 %	12.9 %
42,742,602 (8)	36,955,221 (8)	27,839,284	22,669,942	19,830,941	17,958,263
21,611,266	18,827,288	13,787,005	11,296,183	9,958,940	9,281,992
32,123,974	27,511,000	21,366,642	18,491,003	16,411,115	14,796,732
67.3 %	68.4 %	64.5 %	61.1 %	60.7 %	62.7 %
506	509	495	498	502	517
624,476	546,297	438,184	382,752	338,108	304,673
\$58.44	\$59.97	\$58.33	\$55.93	\$57.71	\$54.21
11.56¢	11.77¢	11.78¢	11.22¢	11.49¢	10.49¢
8.07¢	8.35¢	7.89¢	7.10¢	7.23¢	6.86¢
7.08¢	7.25¢ (9)	7.03¢	6.76¢	6.73¢	6.20¢
53.92¢	59.15¢	60.82¢	65.69¢	77.89¢	59.46¢
16,818	15,175	11,397	9,778	8,620	7,760
199	178	141	124	106	94

(1) The Selected Consolidated Financial Data and Consolidated Financial Ratios for 1992 through 1989 have been restated to include the financial results of Morris Air Corporation (Morris)

(2) Prior to 1993, Morris operated as a charter carrier; therefore, no Morris statistics are included for these years

(3) Pro forma for 1992 through 1989 assuming Morris, an S-Corporation prior to 1993, was taxed at statutory rates

(4) Excludes cumulative effect of accounting changes of \$15.3 million (\$.05 per share)

(5) Excludes cumulative effect of accounting change of \$12.5 million (\$.04 per share)

(6) Includes \$2.6 million gains on sales of aircraft and \$3.1 million from the sale of certain financial assets

(7) Includes \$10.8 million gains on sales of aircraft, \$5.9 million from the sale of certain financial assets, and \$2.3 million from the settlement of a contingency

(8) Includes certain estimates for Morris

(9) Excludes merger expenses of \$10.8 million

(10) Includes leased aircraft

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

### **CORPORATE DATA**

#### **TRANSFER AGENT AND REGISTRAR**

Registered shareholder inquiries regarding stock transfers, address changes, lost stock certificates, dividend payments, or account consolidation should be directed to:

Continental Stock Transfer & Trust Company  
2 Broadway  
New York, New York 10004  
(212) 509-4000

#### **STOCK EXCHANGE LISTING**

New York Stock Exchange  
Ticker Symbol: LUV

#### **INDEPENDENT AUDITORS**

Ernst & Young LLP  
Dallas, Texas

#### **GENERAL OFFICES**

P.O. Box 36611  
Dallas, Texas 75235-1611

#### **ANNUAL MEETING**

The Annual Meeting of Shareholders of Southwest Airlines Co. will be held at 10:00 a.m. on May 20, 1999, at the Southwest Airlines Corporate Headquarters, 2702 Love Field Drive, Dallas, Texas.

#### **FINANCIAL INFORMATION**

A copy of the Company's Annual Report on Form 10-K as filed with the U.S. Securities and Exchange Commission (SEC) may be obtained without charge, as well as other financial information, by writing or calling:

Southwest Airlines Co.  
Investor Relations  
P.O. Box 36611  
Dallas, Texas 75235-1611  
Telephone (214) 792-4908

Company documents filed electronically with the SEC can also be found on the SEC's web site (<http://www.sec.gov>). A copy of this Annual Report and other financial information can be found on Southwest's web site (<http://www.southwest.com>).

## **SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

This Southwest Airlines Annual Report is dedicated to the millions of Americans we give the freedom to fly each year. We are honored to be a part of your lives — to bring you together with your business associates, your friends, and your families.

### **Directors**

Samuel E. Barshop

Chairman of the Board, Barshop & Oles Co., Inc.,  
San Antonio, Texas;  
Audit and Compensation Committees

Gene H. Bishop

Retired, Dallas, Texas;  
Audit, Compensation, and Executive Committees

C. Webb Crockett

Shareholder and Director, Fennemore Craig,  
Attorneys at Law, Phoenix, Arizona;  
Audit Committee

William P. Hobby

Chairman of the Board,  
Hobby Communications, L.L.C.;  
Former Lieutenant Governor of Texas;  
Houston, Texas;  
Audit and Compensation Committees

Travis C. Johnson

Partner, Johnson & Bowen,  
Attorneys at Law, El Paso, Texas;  
Audit Committee

Herbert D. Kelleher

Chairman of the Board, President, and  
Chief Executive Officer of Southwest Airlines Co.,  
Dallas, Texas; Executive Committee

Rollin W. King

Retired, Dallas, Texas;  
Audit and Executive Committees

Walter M. Mischer, Sr.

Managing Partner  
Wheatstone Investments, L.P.,  
Houston, Texas (Real Estate Development);  
Audit and Compensation Committees

## SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM

June M. Morris

Founder and former Chief Executive Officer  
of Morris Air Corporation,  
Salt Lake City, Utah; Audit Committee

### Officers

Herbert D. Kelleher\*

Chairman of the Board, President,  
and Chief Executive Officer

Colleen C. Barrett\*

Executive Vice President — Customers and Corporate Secretary

Gary A. Barron\*

Executive Vice President — Chief Operations Officer

John G. Denison\*

Executive Vice President — Corporate Services

James C. Wimberly\*

Executive Vice President

Carolyn R. Bates

Vice President — Reservations

Donna D. Conover

Vice President — Inflight Service and Provisioning

Alan S. Davis

Vice President — Internal Audit and Special Projects

Michael P. Golden

Vice President — Purchasing

Ginger C. Hardage

Vice President — Public Relations and Corporate Communications

Ross W. Holman

Vice President — Systems

Robert E. Jordan

Controller

Camille T. Keith

Vice President — Special Marketing

Gary C. Kelly\*

Vice President — Finance, Chief Financial Officer

**SOUTHWEST AIRLINES CO. ♥ SIX STORIES OF FREEDOM**

Pete McGlade  
Vice President — Schedule Planning

James F. Parker\*  
Vice President — General Counsel

Ron Ricks\*  
Vice President — Governmental Affairs

Dave Ridley\*  
Vice President — Ground Operations

Joyce C. Rogge\*  
Vice President — Marketing

Roger W. Saari  
Vice President — Fuel Management

Elizabeth P. Sartain\*  
Vice President — People

Jim Sokol  
Vice President — Maintenance and Engineering

Paul E. Sterbenz  
Vice President — Flight Operations

Keith L. Taylor  
Vice President — Revenue Management

Laura H. Wright  
Treasurer

\*Member of Executive Planning Committee

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